No. 19922

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

Kamen & Co., Edward F. Liebert, Abraham Kamen, *et al.*,

Appellants/Cross-Appellees,

vs.

Paul H. Aschkar & Company,

Appellee/Cross-Appellant.

APPELLEE'S BRIEF.

See also Vol. 3346

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vs.

PAUL H. ASCHKAR & COMPANY,

Appellee/Cross-Appellant.

APPELLEES' BRIEF.

Statement of the Case.

A. Facts.

Appellee, Paul H. Aschkar and Company, is an over-the-counter broker-dealer with its sole place of business in Los Angeles. An over-the-counter broker-dealer purchases and sells securities not listed on any national exchange, either for its own account or for customers.

Appellant, Kamen & Co., is a limited partnership engaged in the securities business with its principal place of business in New York. Kamen & Co. is a member of both the New York Stock Exchange and the American Stock Exchange. The other defendants are general partners of Kamen & Co. and employees of Kamen & Co.

Over-the-counter broker-dealers often receive orders from their customers to purchase stocks listed on national exchanges (henceforth listed business). [R. T. 7.] The over-the-counter broker-dealer must execute such orders through a member of the exchange (henceforth listed broker) listing the particular security being purchased or sold. Under the rules of many exchanges the listed broker must receive the full commission fixed by the exchange for the execution of such orders. The over-the-counter broker-dealer places these orders for his customer free of charge as a service to his customers. [R. T. 7-8.] Since the price of the security is determined on the exchange and not by the member of the exchange who executes the order, it makes no difference to the customer which listed broker is used as long as such member executes the order promptly. There is fierce competition by members of national exchanges for the listed business of non-member broker-dealers. Since the rules of the New York Stock Exchange and some other exchanges prohibit commission splitting with non-members, the listed houses have customarily provided reciprocal business to over-the-counter dealers to induce them to place their listed business with them. [R. T. 12; see also: Argument III, *infra* and Report of Special Study of Securities Market of the Securities and Exchange Commission, excerpts from Part 2 and 4 of such report are attached to this brief as Appendix A.] Such reciprocal business takes many forms. One form is for the listed house to "give up" an over-the-counter trade that it could otherwise execute thereby giving the profit from that trade to the non-member broker. [R. T. 8-9, Appendix A, pp. 302 and 304.] The custom of reciprocal business has the approval of the New York Stock Exchange. (Appx. A, pp. 302, 304.)

On July 10, 1963, Mr. Aschkar received a call from Kamen & Co. [R. T. 15.] The caller solicited Paul H. Aschkar & Co.'s listed business and promised to direct over-the-counter business to Paul H. Aschkar & Co. In the same conversation the caller "gave up" to Paul H. Aschkar & Co. the name of a prospective purchaser and prospective seller of 700 shares of Jerome, Richard & Co., Inc., stock, an over-the-counter security. Frederick Cirlin & Associates, Inc., a broker-dealer located in New York, was supposedly interested in selling 700 shares of such stock at $19.25 per share and McNeel & Co., a broker-dealer located in Atlanta, Georgia, was supposedly interested in purchasing such shares for $19.375 per share. [Find. 25; R. T. 15, 16.] To complete the transaction and earn the $87.50 gross profit, Paul H. Aschkar & Co. was required to render the following services:

1. Write up a confirmation slip for the proposed seller and purchaser [Pl. Ex. 1 and 2];

2. Mail such confirmation slip to the seller and purchaser;

3. Receive confirmation from the seller and purchaser [Pl. Ex. 3 and 4];

4. Receive the security from the seller;

5. Pay for the security;

6. Mail such security to the purchaser;

7. Receive payment for the security.

The foregoing services are often referred to as execution and clearance services. (See Appx. A, p. 302.)

The day after the July 10 telephone call, Paul H. Aschkar & Co. received a letter from Kamen & Co.

including a business card of Ross describing him as the manager of the broker-dealer division of Kamen & Co. Kamen & Co. expressly authorized Ross to use such card and had the card printed for him. [Find. 16.]

On July 17, 1963, Kamen & Co. again telephoned Paul H. Aschkar & Co. from New York City and instructed it to execute the following transactions:

> Buy 1000 shares of Jerome, Richard & Co., Inc. common stock from Frederick Cirlin & Associates, Inc. for $19.25 per share and sell such 1000 shares to Handley Investment Company, a company engaged in the business of buying and selling securities located in Tulsa, Oklahoma, for $19.50 per share. This transaction was confirmed by all parties to the transaction. Prior to the delivery of the stock, however, the fraud subsequently described was discovered and Appellee suffered no loss as a result of this transaction.

The foregoing order was placed by Lawrence H. Ross the manager of Kamen & Co.'s over-the-counter broker-dealer division. On the same date Ross again phoned Paul H. Aschkar & Co. and placed a second order as follows:

> Buy 600 shares of Jerome, Richard & Co., Inc. common stock from Guss and Stead Company, a company engaged in the business of buying and selling securities, located in Salt Lake City, Utah, for $19.00 per share and sell such 600 shares to Frederick Cirlin & Associates, Inc. for $19.125 per share. [Finds. 27, 28; R. T. 27, 28.]

During the period of July 10 to July 17, Paul H. Aschkar & Co. placed certain orders for listed business

by calling the telephone number given to it by the employees of Kamen & Co. Kamen & Co. sent written confirmations of such orders to Paul H. Aschkar & Co. and executed such orders on the American Stock Exchange. Kamen & Co. took no risk in executing such orders. The buyer or seller, as the case may be, was furnished by Paul H. Aschkar & Co. and the other party to the transaction was furnished by the Stock Exchange. Kamen & Co. did not even perform the confirmation, shipping and payment service necessary to clear such stock, since such services were furnished to Kamen & Co. by Carl M. Loeb, Rhoades & Co., a large listed broker-dealer with whom Kamen & Co. split its commission in return for such services. Kamen & Co. received $166.00 in commissions for executing such orders. Kamen & Co. has never offered to return these commissions.

In order to give up substantial reciprocal business, the listed broker must have a large volume of over-the-counter business. Kamen & Co. had very little over-the-counter business. [R. T. 258.] Unknown to Paul H. Aschkar and the other defrauded broker-dealers, the reciprocal over-the-counter business "given up" by Kamen & Co. was fraudulently created by Lawrence Ross, the head of Kamen & Co.'s Broker-Dealer Division, and by other employees of Kamen & Co. [Finds. 18 and 25.]

Thus, Ross, Grossinger, and other employees would phone a broker-dealer (hence B) and ask B to purchase Jerome, Richard & Co., Inc. stock from A (another broker-dealer) at X Dollars and to sell it to C at X+ 1/8 Dollars. Unknown to B, C would be induced to purchase from B by another phone call asking him to

purchase from B at X+ ⅛ Dollars and to sell to D at X+ ¼ Dollars, and so on in a long chain, until the bubble finally burst. [Find. 18.] Hundreds of broker-dealers were defrauded in this manner. [Pl. Ex. 52 not admitted into evidence.] Ross and the other employees of Kamen & Co. made these calls by the use of special Wide Area Telephone Service installed by Kamen & Co. for Ross at Ross' request. [Find. 15.]

On July 23, 1964, Paul H. Aschkar & Co. paid a total of $24,875 for the 700 shares purchased on July 10, 1963 and the 600 shares purchased on July 17. The fraud was discovered by the Securities & Exchange Commission on July 24, 1963. Consequently the prospective purchasers of Paul H. Aschkar & Co. refused to take delivery of or pay for the Jerome, Richard & Co. stock and Paul H. Aschkar lost the $24,875 paid by it for the securities. Jerome, Richard & Co.'s stock is and always was worthless. [R. T. 52.] (For a full description of the fraud and its magnitude, see Affidavit of Frances J. Donnelly, investigator for the S.E.C. [Pl. Ex. 52, not admitted into evidence].)

During the period January 7, 1963 to July 19, 1963, the commissions generated by Ross and Grossinger for Kamen & Co. exceeded $182,000. [Pl. Ex. 59.] Although both Ross and Grossinger were registered representatives working on a 40% commission basis, Kamen & Co. paid Grossinger a flat sum of $530.00 per month and paid all of the remaining 40% to Ross. [Pl. Ex. 55 and 56.]

The total amount of the commissions generated by all of the partners and employees of Kamen & Co. (other than Ross and Grossinger), for the period January 1 to July 31, 1963 was $139,000.00. [R. T. 234-235.] During the above period Kamen & Co. had two general

partners and ten employees of which eight were employed throughout the 7-month period. [R. T. 233, 229-232.] During this period, the next highest employee generated commissions of only $14,643.77. [R. T. 233.] The employees as a group generated commissions of only $82,000.00 during this full 7-month period and the two general partners together generated commissions of approximately $50,000.00. Although Ross and Grossinger had only eighteen months and thirty-six months experience in the securities business respectively [R. T. 234, 237], they procured over $40,000.00 more in commissions for Kamen & Co. than the two general partners and ten employees combined and over twelve times the commissions procured by the next highest employee. Moreover, Kamen must have thought that Ross, with only one and one-half years' experience, was generating all of this business since he paid him on the basis of all of the commissions except for $530.00 paid bi-monthly to Grossinger.

For a period of nearly two months,[1] Ross solicited and generated this large volume of business in the same room with Mr. Kamen, Kamen's partner and eight other employees. Mr. Kamen was separated from Ross by only a banister. [R. T. 211, 219.] Thereafter, from March 1 to July 24, 1963, the solicitations took place in a separate office furnished by Kamen & Co. to its special over-the-counter division. This office adjoined Mr. Kamen's office, being separated therefrom by an ordinary office wall.

Nevertheless the Court found that the partners of Kamen & Co. did not know or have reason to know of the fraud being committed by the manager of their broker-dealer division.

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[1]January 7, 1963 to the end of February, 1963.

The court, however, further found that the fraudulent scheme was perpetrated by the managerial and other employees of Kamen & Co. within the scope of their employment and that such fraud was engaged in by such employees for the purpose of inducing various broker-dealers to give their listed business to Kamen & Co., which was the object of their employment. [Find. 21.] Moreover, the court found that the fraudulent employees were hired by Kamen & Co. for the specific purpose of soliciting a large volume of listed business from over-the-counter dealers [Find. 12], that in order to obtain such business Kamen & Co. established a broker-dealer division and gave Ross and Grossinger actual authority to manage such division and implied actual authority to place over-the-counter orders with certain broker-dealers [Find. 13], that the fraudulent employees were actually authorized to use and did actually make substantial use of the offices and equipment of Kamen & Co. to carry out their fraudulent scheme [Find. 15], that the fraudulent employees had actual authority to solicit business from appellee and other broker-dealers, that the fraudulent employees had ostensible authority to make the false representations and engage in the fraudulent conduct heretofore described [Find. 22] and that the fraudulent employees were vested by Kamen & Co. with ostensible authority to offer and place the fraudulent Jerome, Richard & Co. Inc. transactions. [Find. 23.] Although the trial court was of the opinion that the practice of giving reciprocal business of the nature given in this case violated the New York Stock Exchange Rules so far as Kamen & Co. was concerned, it found that these practices were not illegal insofar as the Paul H. Aschkar & Co. participation therein was concerned and, though unusual,

not so unusual as to put Paul H. Aschkar & Co. upon notice or require it to investigate or doubt the extent of the authority extended to Ross and Grossinger. [Find. 35.]

The court further found that Ross and Grossinger impliedly represented that the over-the-counter transactions placed by them were bona fide business transactions [Find. 19] and that Paul H. Aschkar & Co. was not negligent in relying upon the representations made by Ross and Grossinger but to the contrary was justified in relying thereon. [Finds. 29, 36.]

B. Appellants' Contentions.

Appellants contend that:

1. the Court of Appeals should ignore the findings of the trial court and retry *de novo* the factual questions which determine Kamen & Co. liability for the acts of its employees;

2. the trial court was clearly erroneous in finding that the fraud heretofore described was committed by appellants' manager and other employees within the scope of their employment and within the ostensible authority and agency power vested by appellants in such manager and other employees;

3. whenever a fraud involves the successive victimization of a number of persons arranged in a chain transaction, a person who has suffered an actual cash loss of $24,875 must proceed against the prospective victim following him in the chain before proceeding against the persons perpetrating the fraud.

These contentions are discussed in Arguments I-III, *infra*. None of them are sustained by the facts of this case or the law pertaining thereto.

ERRORS RELIED UPON BY CROSS-APPELLANT.

The judgment of the trial court is fully supported by its Findings of Facts and Conclusions of Law. Appellee, however, believes that the same judgment is required on legal and factual bases either ignored by the trial court or rejected by that court. Consequently, appellee has filed a cross-appeal. Cross-appellant's errors relied upon are:

1. The trial court erred in failing to conclude that the duties imposed by the Securities Act of 1933 and the Securities Exchange Act of 1934 on members of national exchanges are non-delegable and that any violation thereof by an employee renders his employer civilly liable to the same extent as if the employer himself violated the Acts.

2. The standard of care imposed by the trial court on a member firm of the New York Stock Exchange in supervising the activities of its employees was shockingly inadequate.

3. The court erred in refusing to admit into evidence a report in affidavit form prepared by an investigator for the Securities and Exchange Commission in the performance of his official duties proving that Appellants had knowledge of the fraud being committed by their employees.

OUTLINE OF ARGUMENT.

I.

This Appellate Court Should Not Retry *De Novo* the Questions of Apparent Authority and Whether the Fraud Was Committed in the Scope of the Employment of the Manager of Kamen & Co.'s Broker-Dealer Division. Such Questions Are Questions of Fact and the Trial Court's Findings Thereon Should Not Be Set Aside Unless Clearly Erroneous.

II.

The Evidence Fully Supports the Trial Court's Findings That the Manager of Kamen & Co.'s Broker-Dealer Division Perpetrated the Fraud While Acting Within the Scope of His Employment, That Such Manager Was Ostensibly Authorized to Place the Fraudulent Jerome, Richard Transactions and That Appellee Was Not Negligent in Relying Upon Such Manager's Misrepresentations.

1. Appellants Are Liable for the Acts of the Manager of Their Broker-Dealer Division Because Appellants Vested Such Manager With the Apparent Authority to Place the Fraudulent Reciprocal Transactions.

2. Appellants Are Liable for the Acts of the Manager of Their Broker-Dealer Division Because Such Manager Committed the Fraud While Acting Within the Scope of His Employment.

III.

A Victim of a Fraud Which Involves the Successful Victimization of a Number of Persons Arranged in a Chain Transaction Is Not Required to Proceed Against the Prospective Victim Following Him in the Chain Before Proceeding Against the Persons Perpetrating Such Fraud.

IV.

A Member of the Securities Industry Has a Non-Delegable Duty to All With Whom He Deals to Deal Honestly and Fairly.

V.

The Standard of Care Imposed by the Trial Court on New York Stock Exchange Member Firms for the Supervision of Their Employees Failed to Conform to Current Standards and Is Reminiscent of a Rejected Era in the Securities Industry.

VI.

The Trial Court Erred in Refusing to Admit the Certified Affidavit of Francis J. Donnelly.

ARGUMENT.

I.

This Appellate Court Should Not Retry De Novo the Questions of Ostensible Authority and Whether the Fraud Was Committed in the Scope of the Employment of Kamen & Co.'s Broker-Dealer Division. Such Questions Are Questions of Fact and the Trial Court's Findings Thereon Should Not Be Set Aside Unless Clearly Erroneous.

The trial court heard testimony for three days concerning the purpose for which Ross and Grossinger were employed, the duties they performed, the responsibilities placed upon them, the authority actually and impliedly granted to them, the title given to Ross, the direct and indirect communication by Kamen & Co. of Ross's responsibilities and powers, the conduct of Ross and Grossinger while employed by Kamen & Co. and all of the facts bearing on the relationship among Kamen & Co., Ross, Grossinger and appellee. After hearing such testimony the trial court found that Ross and Grossinger perpetrated the fraudulent Jerome, Richard & Co., Inc. transactions while acting within the scope of their employment [Find. 21] and further found that these employees possessed the ostensible authority to place the fraudulent Jerome, Richard transactions. [Finds. 22, 23.]

Federal Rule of Civil Procedure 52a provides that such findings shall not be set aside unless "clearly erroneous."

Appellants, however, contend that Rule 52a does not apply "where there is no substantial dispute as to the evidentiary facts from which ostensible authority is to be determined. . . ." (App. Br. p. 14.)

This contention has been expressly rejected by the Supreme Court in *C.I.R. v. Duberstein,* 363 U.S. 278, 289, 291, 80A S. Ct. 1190, 1198-1200, 4 L. Ed. 2d 1218, 1227-1228 (1960), by the Ninth Circuit Court of Appeals in *Lundgren v. Freeman,* 307 F. 2d 104, 113-115 (9th Cir. 1962), and by the Advisory Committee note to Federal Rule 52a.[2]

Thus, in *C.I.R. v. Duberstein, supra,* the Supreme Court reviewed two cases in which the triers of fact were required to determine whether a transfer of property was a gift exempt from income tax or compensation subject to tax. In each case the facts were undisputed. Nevertheless the court held that the trier of facts resolution of this question could not be set aside unless clearly erroneous. The court stated that Rule 52a applies "also to factual inferences from undisputed facts." (*Id.,* at 291.) Moreover, the court expressly criticized the technique of formulating a question as a "mixed question of fact and law" in order to permit a broader scope of view. (*Id.,* at 289, footnote 11.)

In *Lundgren v. Freeman, supra,* the trial court found that, due to a mutual mistake, a written contract did not properly reflect the intent of the parties. In that case as in this one, appellant argued that the findings

[2]The Advisory Committee's Note states:

"It (the clearly erroneous rule) is applicable to all classes of findings in cases tried without a jury whether the finding is of a fact concerning which there was a conflict of testimony, of a fact deduced or inferred from uncontradicted testimony." (Words in parentheses added.)

of the trial court should be ignored because they were based on undisputed facts. After a careful analysis of this question and an extended discussion of the predominant case law and comments of Judge Clark, Judge Frank and Professor Moore this court held:

> "We are bound by Rule 52a F.R. Civ. P., which provides that: 'findings of fact shall not be set aside unless clearly erroneous. * * *' Therefore, we may not substitute our judgment if conflicting inferences may be drawn from the established facts by reasonable men, and the inferences drawn by the trial court are those which could have been drawn by reasonable men." (*Lundgren v. Freeman,* 307 F. 2d at 113.)[3]

The holding of *Lundgren* has been reaffirmed by this court every year since 1962. (*Teren v. Howard,* 332 F. 2d 949, 952 (9th Cir. 1963), [Extent of domination of President of corporation over board of directors]; *United States v. First Security Bank,* 334 F. 2d 120, 121 (9th Cir. 1964), (whether income was properly part of an insurance business. or banking business); *Stauffer Laboratories Inc. v. F.T.C.,* 343 F. 2d 75, 78 (9th Cir. 1965), [whether text of ads are misleading].)

The test of whether an inference drawn from undisputed facts is a conclusion of law or a factual determination depends upon whether such inference is derived from having had "experience with the mainsprings of human conduct." (*C.I.R. v. Duberstein,*

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[3]See also *Widney v. U.S.,* 178 F. 2d 880 (10th Cir. 1949)

"If, from the established facts, reasonable men might draw different inferences, it is not within the province of this court to substitute its judgment for that of the trial court as to which inferences should be drawn."

supra, 363 U.S. at 289; *Lundgren v. Freeman, supra,* 307 F. 2d at 115.)[4]

Clearly, the inferences which must be drawn from evidentiary facts to determine whether the acts of a principal vested his agent with ostensible authority, the extent of the ostensible authority, the reasonableness of a third

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[4]The cases cited by appellants are distinguishable on this basis. Thus, in the case of *Kippen v. American Automatic Typewriter Company,* 324 F. 2d 742 (9th Cir. 1963), cited by appellants, the Court held that the law imposed a legal duty on defendant to warn plaintiff to stop drinking before defendant's franchise could be terminated for good cause. The trial court, however, through its finding indicated that no such warning was required. In *Brown v. Cowden Livestock Co.,* 187 F. 2d 1015 (9th Cir. 1951) this court held that as soon as plaintiff discovered that defendant had paid the purchase price for plaintiff's cattle to plaintiff's agent, plaintiff was under a legal duty to advise defendant that such agent was not authorized to receive payment. This court further held that, as a matter of law, plaintiff could not permit its agent to retain part of the purchase price as a loan from plaintiff and at the same time take the position that it had not received the payment from defendant.

In *Stevenot v. Norberg,* 210 F. 2d 615 (9th Cir. 1954), the trial court was of the opinion that certain employees had vested rights to continued employment. On the basis of this erroneous legal view the court found that it would be in the best interest of the bankruptcy estate not to fire such employees. The appellate court held that this "finding" was not binding on it because the Finding was based upon the erroneous legal conclusion that such employees had a right to continued employment and that in any event the discretion to fire or hire employees was vested by a former order of the trial court in the trustee for the estate and thus should not be interfered with by the trial court.

In *Plomb Tool Co. v. Sanger,* 193 F. 2d 260, 264 (9th Cir. 1952) the appellant challenged the trial court's conclusions of law, not its findings of fact.

The two trademark cases cited by appellant are likewise inapposite. In *Fleischmann Distilling Corp. v. Maier Brewing Company,* 314 F.2d 149 (9th Cir. 1963) the trial court was under a legal misapprehension that a similarity of product was required before the Lanham Act is applicable. Moreover, the courts have historically applied a different standard of review in patent and trademark cases. (See Yankowitch, *Findings in the Light of the Recent Amendments to the Federal Rules of Civil Procedure,* 8 F.R.D. 271, 291 (1948).)

party's reliance on such ostensible authority, the purpose for which an employee is hired and whether specific acts are within the scope of such employment are derived from the "mainspring of human conduct." To resolve such issues the trier of fact must determine the meaning which a reasonable person would attribute to the conduct of all the persons involved in the many varying factual circumstances of each case. This is exactly the kind of fact finding that the decisions of *C.I.R. v. Duberstein* and *Lundgren v. Freeman* have reserved to the trier of fact.

Thus, the question of ostensible authority has been held to be a question of fact not only in the Fifth Circuit case cited on pages 14 and 15 of appellants' brief (*Bogue Electric Mfg. Co. v. Coconut Grove Bank,* 269 F. 2d 1, 4 (5th Cir. 1959), but also in an additional Fifth Circuit case (*Gilmore v. Royal Indemnity Co.,* 240 F. 2d 101, 105-106 (5th Cir. 1956) and in cases from the Second Circuit (*Farmer v. Arabian American Oil Co.,* 277 F. 2d 46, 52 (2nd Cir. 1960)), the Third Circuit (*Lind v. Schenley Industries, Inc.,* 278 F. 2d 79, 84 (3rd Cir. 1960)), the Eighth Circuit (*Frank Sullivan Company v. Midwest Sheet Metal Works,* 335 F. 2d 33, 40 (8th Cir. 1964)) and the Tenth Circuit (*J. T. Majors & Sons, Inc. v. Lippert Bros. Inc.,* 263 F. 2d 650, 654 (10th Cir. 1958), *American Nat. Bank of Sapulpa, Okl. v. Bartlett,* 40 F. 2d 21, 22 (10th Cir. 1930)).[5]

[5]The law of California, similarly, provides that the question of ostensible authority and the extent of an agents ostensible authoirty is a question of fact unless the evidence is so conclusive that reasonable men can draw only one conclusion therefrom. (*State F. Co. v. Hershel Calif. F.P. Co.,* 8 Cal. App. 2d 524, 527 (1935). In *State F. Co. v. Hershel Calif. F.P. Co.,* 8 Cal. App. 2d at 528, the court stated "the existence of an agency, like the extent of an agent's authority, is a question of fact." (Accord: *California Viking Sprinkler Co. v. Pacific Indem. Co.,*

Likewise in *Garebedian v. Griffin Steel & Supply Co.* 340 F. 2d 478, 479-480 (9th Cir. 1965) this Court applied the clearly erroneous rule to a finding by a referee in bankruptcy that the person served with process was not an agent possessing sufficient actual or apparent authority to validate such service.

Not only is appellants' legal argument that the question of ostensible authority is a question of law untenable but their assertion that the facts involved in this case are undisputed is unfounded. The facts relating to the question of appellee's justifiable reliance on the representations made by Ross and Grossinger were very much in dispute. (Compare the testimony of appellants' expert witness [R. T. 391] and Paul H. Aschkar [R. T. 81-90] and John B. Bailey [R. T. 163-165].) Although the evidentiary facts relating to Ross's actual authority, apparent authority and scope of employment were not basically in dispute, such facts permitted the court to draw widely varying inferences as to the extent of Ross's apparent authority and scope of employment. The trial court's finding that the fraud was perpetrated by Ross and Grossinger while they were acting within the scope of their employment and that they were ostensibly authorized to place the fraudulent transactions should therefore not be disturbed unless they are clearly erroneous.

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213 Cal. App. 2d 844, 850 (1963); *Torrance N. Bk. v. Enesco F. Credit Union,* 134 Cal. App. 2d 316, 325 (1955); *Maron v. Swig,* 115 Cal. App. 2d 87, 90 (1952) [a fraud case]; *House Grain Co. v. Finerman & Sons,* 116 Cal. App. 2d 485, 492 (1953) ["The issue of ostensible agency is one of fact"]; *Thompson v. Machado,* 78 Cal. App. 2d 870, 877 (1947); *Ghiglione v. American Trust Co.*, 49 Cal. App. 2d 633, 638 (1942) [fraud by employee]; *United Air Services, Ltd. v. Sampson,* 30 Cal. App. 2d 135, 140-141 (1938); *Bridge v. New Amsterdam Casualty Co.,* 129 Cal. App. 365, 367-368 (1933).) The one case cited by appellants, *Fairbanks v. Crumb Inc. etc. Co., Inc.,* 108 Cal. App. 197, 210 (1930) is the only case containing a statement to the contrary and as to such statement must be deemed to be overruled.

II.

The Evidence Fully Supports the Trial Court's Findings That the Manager of Kamen & Co.'s Broker-Dealer Division Perpetrated the Fraud While Acting Within the Scope of His Employment, That Such Manager Was Ostensibly Authorized to Place the Fraudulent Jerome, Richard Transactions and That Appellee Was Not Negligent in Relying Upon Such Manager's Misrepresentations.

The court found that appellants are liable for the acts of the manager of their broker-dealer division because:

(1) Appellants vested such manager with the ostensible authority to place the fraudulent reciprocal transactions, and

(2) Such manager committed the fraud while acting within the scope of his employment.

Since these findings provide two distinct and separate bases for appellants' liability for the acts of their employees, appellee will discuss them under separate subheadings.

1. Appellants Are Liable for the Acts of the Manager of Their Broker-Dealer Division Because Appellants Vested Such Manager With the Ostensible Authority to Place the Fraudulent Reciprocal Transactions.

A principal is liable for the tortious acts and statements of his agent if the agent purported to speak for his principal and there was reliance upon ostensible authority or if the agent was aided in the commission of the tort by the agency relationship. (*Gleason v. Seabord Ry.*, 278 U.S. 349, 353-354; 49 S. Ct. 161, 161-162; 73 L. Ed. 415, 417-418 (1929); *Rutherford v.*

Rideout Bank, 11 Cal. 2d 479, 484 (1938); Rest. of Agency §§219 (2) (d), 257, 266.)

Appellants admit that in the early part of January, 1963, they hired Ross for the purpose of soliciting listed business from broker-dealers all over the United States. [R. T. 226, 245-246.] A special division was formed within Kamen & Co. for this purpose and Ross was put in full charge thereof. Ross was furnished with a separate office and with three employees, a registered representative, a secretary and a clerk. [R. T. 208.] Specialized telephonic equipment was put at Ross's disposal and he was authorized to offer to broker-dealers a variety of special services and research material in return for their listed business.

It is clear that, without the facilities of Kamen & Co. and the position occupied by Ross as the manager of its broker-dealer division, the fraud would have been impossible. Thus, the agent was aided in the commission of the tort by the agency, relationship. This basis of liability is often referred to as agency power.

In the instant case, however, there was not only agency power but also ostensible authority. Ross, as manager of the broker-dealer division was not just an employee but an executive with wide authority over the operations of his division.

Appellants expressly and impliedly communicated Ross's broad authority to each of the broker-dealers throughout the United States with whom Kamen & Co. desired to establish a business relationship. Thus, appellants printed a business card for Ross describing him as the manager of the broker-dealer division of Kamen & Co., and authorized Ross to send such cards

to appellee and others. Appellants authorized Ross to call various broker-dealers throughout the United States, to introduce himself as the manager of appellants' broker-dealer division, and to solicit the broker-dealer listed business for Kamen & Co. Appellants confirmed and executed the listed business procured by Ross. Appellants made the specialized research facilities of its clearing agent, Carl. M. Loeb, Rhoades & Co., available to the broker-dealers contacted by Ross [R. T. 274-276] and gave such broker-dealers expensive phone privileges and special price quotation services. [R. T. 273-274.]

The foregoing conduct of appellants, coupled with the custom of reciprocal business in the securities industry, quite naturally indicated to the broker-dealers solicited by Kamen & Co. that Ross was the person responsible for distributing Kamen & Co.'s reciprocal business, thus vesting Ross with the ostensible authority to do so.[6] Appellants do not seriously dispute Ross's ostensible authority to give up legitimate over-the-counter transactions. Appellants argue, however, that the Jerome, Richard trades fell outside the regular and ordinary course of business and thus appellee was unreasonable in relying on the ostensible authority vested by them in Ross. This contention is of course directly contrary to the court's finding that appellee was "not negligent in relying on the representations of Ross and Grossinger and was justified in relying thereon." [Find. 29.]

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[6]This is the complete answer to appellants suggestion that appellee should have checked with a principal of Kamen & Co. (App. Br. p. 30). Appellee was already in touch with Ross, the manager of their broker-dealer division who was vested by appellants with so much authority, that he was the only one with whom a reasonable person would check.

In order to buttress their contention that appellee was not justified in relying on Ross's misrepresentations, appellants conjured up six items connected with the transactions which they deem to be unusual. (Footnote on page 21 of Appellants' Brief.)

Appellants state that the transactions were unusual because the profit appellee was to receive on the Jerome, Richard transactions exceeded the commission business that appellee had given to Kamen & Co. This was certainly true on July 10, 1963 since on that day Kamen & Co. gave up a transaction on which Paul H. Aschkar & Co. was to earn $87.50 and Paul H. Aschkar & Co. had not yet given any business to Kamen & Co. This trend, however, was quickly reversed and by July 16th (one day prior to the next order given up by Kamen & Co.) appellee had placed orders with Kamen & Co. on which they realized commissions of $118.25. [R. T. 128.] On the next day, Kamen & Co. gave two more orders to appellee which, when executed, would have given appellee a gross profit of $324.50. Thereafter, appellee gave Kamen & Co. additional listed business, the exact amount of which does not appear in the record. Kamen earned $48.75 on such business and had other listed orders on hand when the fraud was discovered.

Reciprocal business arrangements between a New York Stock Exchange Member and a non-member usually require the non-member firm to give up to the member firm between $1.50 to $3.00 of commissions for each $1.00 of business given by the member firm to the non-member. (Appx. A, p. 302.) Although in the aggregate the ratio always favors the member firm, it is clear that at any one particular moment, over a short period of time (*i.e.* in the instant case less than three weeks),

the member firm may be behind. Legitimate business can only be given up when an order is placed by a customer. Sometimes the non-member firm gets a large number of listed orders and sometimes the member firm gets a large number of over-the-counter orders. The member firm can only give up the over-the-counter orders when and as it receives them. Over a substantial period of time, however, the member firm will receive more than it gives up, otherwise it will withdraw from the arrangement. The fact that during part of a three-week period Kamen & Co. gave up more than it received is certainly not an unusual circumstance.

In order to buttress their contention that such circumstance is unusual, appellants deduct from the commissions actually received by Kamen & Co. the salary of its employees and the amount paid by it to its clearing agent. It is clear, however, that both non-member firms and member firms must pay salaries and other expenses from their gross earnings. Appellee cleared its own transactions. Presumably appellant paid for a clearing agent because it found that arrangement more economical than hiring employees for that purpose.

The second unusual circumstance conjured up by appellants is that, after the transactions had been entered into, appellee received an instruction to either take delivery from a broker who was not a seller or to deliver to a broker who was not the buyer.

The clearing and shipment of stock takes time. Thus, on July 23rd appellee first received the 600 shares purchased on July 10th and still had not obtained delivery of 1,000 shares purchased on August 17th. Often a sale can be made in the intervening time. This is all that

such "change order" indicates. It is true that Paul H. Aschkar could deduce from such change order (if he dissected the transactions) that four brokers had purchased the shares either for themselves or for customers at slightly higher prices. The period of time over which such rise took place could not be ascertained from the documents in appellants' possession but as indicated in this case such period could easily encompass thirteen days. Certainly a rise of ½ to 1 point over a period of two weeks on a stock selling at $19 is not unusual; nor is the fact that the stock has risen in 1/8 or ¼ increments unusual. Appellants brought a professional expert witness all the way from New York. Yet such witness did not testify that the change orders or price increases were unusual circumstances.

Thirdly, appellants contend that the disclosure of the lower seller by Cirlin & Associates was unusual. The only reason for Cirlin to not disclose the lower seller is to prevent appellee from going directly to such source of supply. Appellee, however, was not making a market in Jerome, Richard stock. Cirlin had little to fear from him. Can it truthfully be said that the court was clearly erroneous in finding that appellee was not negligent because, after receiving such change order, appellee did not immediately say to himself, "Why isn't Cirlin afraid that if some time in the future I have a need for Jerome Richard stock I will first check with the other broker, whose name he revealed to me in his change order?"

Fourth, appellants contend that the transactions were unusual because over a period of eight minutes the price of the stock fluctuated by 1/8th of a point and thus eight minutes later Cirlin had to purchase the stock

for 1/8th more than it has previously sold similar shares. The only testimony in the record states that this is not at all unusual. [R. T. 294.] A specialist either on an exchange or over the counter continuously purchases and sells stock at slightly varying prices minutes apart. [R. T. 182-183.] Appellants further contend that it must have seemed strange that appellee could always find a buyer at a higher price than Cirlin who, since he had three transactions in the Jerome Richard stock, must have seemed to be relatively active in the stock. Three transactions are hardly an indication that someone is very active in a stock. Moreover, it was Kamen & Co. and not appellee who found the buyer at a higher price and Kamen & Co. appeared at least as active in the stock as Cirlin.

The fifth unusual circumstance pointed to by appellants is that the stock did not appear in the "pink sheets" within three months of the transactions in question. This statement is incorrect. There was a listing "OW" "BW" (offer wanted, bid wanted) within a few days of the transaction. [R. T. 86.] Moreover, there was a price of $17 quoted in May approximately six weeks previously. The fact is that it is very common for the pink sheets to list stock "OW" "BW." This merely means that the broker who is called by the quotation service is not willing to give a price in the absence of a concrete transaction involving a definite number of shares. Again there is absolutely no testimony, not even by appellants' expert witness that such listings or the absence of a definite price for the time period here involved is unusual.

The sixth unusual aspect asserted by appellants is that there was no confirmation or acknowledgement be-

tween appellants and Kamen & Co. concerning the Jerome, Richard transactions. Appellee sent confirmation slips to the buyer and seller of the stock. Kamen sent confirmation slips in regard to the listed business given to it by appellee. These are the only written confirmations which are customary in the industry. The "give-up" itself was accomplished by telephone. Most of the business in the securities field is accomplished over the telephone. It is not unusual that the Jerome Richard trades were not further acknowledged by appellee and Kamen. The fact that this is not unusual is borne out by the apparent absence of such communication to Kamen & Co. from any of the other hundreds of broker dealers called by Ross and Grossinger. Here also there is no testimony whatsoever supporting appellants' assertion that the absence of such written communications is unusual.[7]

Consequently, although appellants have laboriously analyzed and dissected the Jerome, Richard transactions, the record fails to disclose any unusual circumstance connected with the transaction other than appellants' professional witnesses [R. T. 373] testimony that the "give up" of both a buyer and a seller is very unusual. Appellants further contend and the trial court held that such a "give up" violates the New York Stock Exchange Anti-rebate Rule.

Appendix A hereto contains part of the study of the Securities and Exchange Commission into "give-ups" and other forms of rebate by New York Stock Exchange members to non-members.

[7]Likewise there is absolutely nothing in the record to support appellants', insinuation that Paul H. Aschkar intentionally or otherwise "kept the transaction to himself." (App. Br. p. 30.)

This study shows that a large number of so-called "fixed profit" reciprocal business arrangements are accepted by the New York Stock Exchange as not violating its Anti-rebate Rule.

Thus, on page 302, the S.E.C. Study states:

> "The member desiring to reciprocate for commission business given him by a nonmember professional can do so by returning commission business to the nonmember. There are several methods, only the most important of which can be mentioned here: he may place business on a regional exchange with a nonmember who is a member of that exchange even though (a) the member is also a member of the regional exchange (dual member) and could have placed the business there directly or (b) the security is traded on the NYSE as well as the regional exchange (dual listing) so that the dual member could have effected the transaction directly on the NYSE."

The foregoing is a fixed profit transaction, the member firm supplies the buyer or seller for the security and the regional exchange supplies the other party to the trade. The regional exchange member merely performs the clearing duties also performed by appellee in this case.

The S.E.C. Study goes on to state:

> "He may place orders for unlisted securities with the nonmember to be transacted over the counter, even though the member firm may have a trading department capable of effecting the transaction directly."

This, of course, is what appeared to appellee to be taking place in the instant case. Kamen & Co. appeared to have completed an over-the-counter trade which they turned over to appellee in return for the business they hoped to receive from appellee.[8] The S.E.C. Study states:

> "Return by an NYSE member of cash to his reciprocal correspondent for commission business would violate the antirebate rule cited above, but the return of a cash equivalent in the form of profitable security commission business which might have been transacted directly by the NYSE member is permissible. The distinction is obviously a fine one and it has produced a fertile field for administrative interpretation."

Of course a transaction arranged solely for the purpose of giving a profit to an over-the-counter broker-

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[8]There are numerous other reciprocal business arrangements through which over-the-counter broker-dealers are given fixed profit transactions either by member firms in return for listed business or by mutual funds in return for selling mutual fund shares. In many of these arrangements the over-the-counter broker-dealer is provided with both a buyer and seller. (See Appendix A, part 4, pp. 224-228.) These arrangements have the express or tacit approval of the various exchanges including the New York Stock Exchange. Apparently these arrangements are not questionable if (as in the instant case) the broker-dealer performs the expensive and time-consuming execution and clearance services. Kamen & Co. pays as much as 40% of its commissions to Carl M. Loeb, Rhoades & Co. for these clearance services.

Many exchanges other than the New York Stock Exchange and American Stock Exchange expressly permit rebates to broker-dealers who, like appellee, are members of the National Association of Securities Dealers. (Report of Special Study of Securities Markets of the Securities and Exchange Commission Part 2, pp. 299-300.)

It is to be noted that in this case (as opposed to some mutual fund situations) there existed no conflict of interest. The listed securities were purchased for the minimum commission set by the exchange and could not be purchased for less.

dealer violates the rebate rule. Appellee, however, did not know that the Jerome, Richard transactions were not legitimate trades received by Kamen & Co. but were in fact "arranged transactions" fraudulently induced by the manager of appellants' over-the-counter division. [Finds. 25, 27, 32, 18.]

It is because of the foregoing custom of reciprocal business that Mr. Bailey testified that a reasonable broker's suspicion would not be aroused by the Jerome Richard transactions [R. T. 163-165] and that Paul H. Aschkar testified that he was not suspicious of the transaction. [R. T. 81, 90.][9]

In light of the New York Stock Exchange's express approval of the reciprocal business transactions set forth in the record and the S.E.C.'s report, the accuracy of the court's conclusion that the "give-ups" involved in this case violated the rules of the New York Stock Exchange is open to serious doubt.[10] In any event, re-

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[9]The fact that appellee did not have a previous similar transaction is totally irrelevant. He was aware of the custom of reciprocal business in the industry [R. T. 15], even though he had not been "favored" with this particular type of reciprocity before.

Appellants' expert witness's testimony that the transaction would make "his hair stand on end" is not persuasive. Mr. Cohon has a very strange view of the usual. To him the Jerome, Richard transactions were very unusual but Ross's earnings in the amount of $182,000 over a few months period was not at all unusual. In his view these huge earnings were merely reward for "hard work". [R. T. 378-379, 399 but compare 397.] The trial court had the opportunity to observe appellants' expert witness and obviously did not set great store in his testimony.

[10]Appellants often refer to the "illegality" of the purported rebate. With all due respect to the New York Stock Exchange, its rules are not law. To the contrary it is very likely that the antirebate rule of the Exchange is a *per se* violation of the Sherman Anti-Trust Act and is therefore totally invalid. (*Silver v. New York Stock Exchange,* 373 U.S. 341, 357, 83 S.Ct. 1246, 1257, 10 L. Ed. 2d 389, 400 (1963); *United States v. Socony-Vacuum Oil Co.,* 310 U.S. 150, 210, 60 S.Ct. 811,

gardless of whether such transactions fell on one side or the other of the fine line drawn by the exchange, the trial court's finding that the transactions, although "unusual, were not so unusual *or* shocking[11] as to put the plaintiff upon notice or require it to investigate or doubt the extent of the authority extended to Ross and Grossinger" [Find. 35] and its further finding that appellee "was not negligent in relying on the representations made by Ross and Grossinger but was justified in relying thereon" [Finds. 29, 36] are certainly not clearly erroneous.

2. Appellants Are Liable for the Acts of the Manager of Their Broker-Dealer Division Because Such Manager Committed the Fraud While Acting Within the Scope of His Employment.

Even if the reciprocal transactions offered by Ross were unusual, appellants would nevertheless be liable for the tortious acts of their employees committed within the scope of their employment.

The basic Restatement of Agency section dealing with an employer's liability for the *torts* of his employees is § 219. This section provides:

> "§219. When Master Is Liable for Torts of His Servants.[12]

838; 84 L. Ed. 1129, 1161 (1940); See, Jennings, *The New York Stock Exchange and the Commission Rate Struggle,* 53 Calif. Law Rev. 1119, 1131-1140.)

[11](Emphasis added.) The court used the disjunctive between the words "so unusual" or "shocking", thus finding that the transaction was neither so unusual nor so shocking as to put plaintiff on notice. It is clear, therefore, that contrary to appellants' contention (App. Br., p. 23) the court was not of the opinion that the transaction had to be shocking before plaintiff's reliance would be unjustifiable.

[12]Under the restatement definition Ross and Grossinger were servants of Kamen & Co. (See Rest. of Agency 2d § 220.)

(1) A master is subject to liability for the torts of his servants committed while acting in the scope of their employment.

(2) A master is not subject to liability for the torts of his servants acting outside the scope of their employment, unless:

(a) the master intended the conduct or the consequences, or

(b) the master was negligent or reckless, or

(c) the conduct violated a non-delegable duty of the master, or

(d) the servant purported to act or to speak on behalf of the principal and there was reliance upon apparent authority, or he was aided in accomplishing the tort by the existence of the agency relation."

Section 219 contains two numbered subsections. Under subsection (1) the only question is; did the employee act within the scope of his employment? If so, the other questions raised by subsection (2); the master's intent, the master's negligence, the violation of a non-delegable duty and the existence of apparent authority (and reasonable reliance on apparent authority) never arise.[13]

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[13]Appellants' reliance on §§166, 258, 261 and 262 of the Restatement of Agency is misplaced.

§166 applies only to the power of an agent to bind his principal to a contract. Thus Chapter 6 including §§140-211 is entitled "Liability of Principal to Third Persons, Contracts and Conveyances", while Chapter 7 including §§212-267 is entitled "Liability of Principal to Third Persons, Torts". (See 1 Rest. of Agency, pp. 346, 451.) The power of a servant to render his principal liable for a tort is far greater than his power to bind him to a contract. That is why the two subjects are treated separately in the Restatement.

Restatement of Agency §§261 and 262 cited by appellants are likewise inapposite. A fraud may be committed by an employee

In a tort case, the normal or unusual appearance of the tort is totally irrelevant. In most cases this is too clear for argument. Driving at excessive speeds or assuming a belligerent attitude towards a customer and

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solely to benefit himself or to benefit both himself and his employer. The latter are usually commission cases. An employee of course rarely commits a fraud solely to benefit his employer. When a fraud is committed solely to benefit the employee, it is not committed in the scope of the servant's employment. In such cases liability of the employer rests solely on apparent authority or agency power. Sections 261 and 262 of the Restatement are intended to apply to these torts. Thus the Reporter's Notes to §261 provide:

> "§261 Agent's position Enables Him to Deceive." This note deals primarily with the situations in which the agent acts on his own account and not in the interests of the principal and hence includes cases involving not only the rule stated in this section but also the rule stated in §262. . . . (Restatement of Agency 2d Appendix, p. 420.)

In the instant case, although Ross received a portion of the commissions, the fraud was perpetrated to increase the business of Kamen & Co.

Moreover, even under the rules stated in §§261 and 262 appellants are liable. The whole of §262 Comment "c" (only a portion of which is quoted by appellants) provides:

> "Third Person vs. Principal
>
> c. *Contributory negligence on the part of the deceived person is not generally recognized as a defense,* However, if a third person should know or otherwise has notice that an agent is acting for his own purposes or is otherwise violating his authority, the principal is not liable. See §§165 and 166." (Emphasis added.)

Comment *c* includes the words "otherwise violating his authority", however, since Sections 261 and 262 were intended to apply solely to frauds committed by an employee for his own account and thus committed outside the scope of his employment, the comments thereto must be read in this context. The proper interpretation of Comment *c* to Section 262 is that appellants are not liable if appellee knew or should have known that Ross was intending only to benefit himself, or was otherwise acting outside the scope of his employment.

This appellee could not know since Ross clearly was benefiting his employer and Ross was doing exactly what he was hired to do, soliciting listed business from over-the-counter broker-dealers. As is explained in the text *infra* the fact that Ross used prohibited

then punching him in the nose always differs from the customary transaction. Moreover, such acts are never actually or even apparently authorized. The principal is liable, however, because they are performed within the scope of the servant's employment.

California, federal case law, a large number of other jurisdictions and Mechem, a leading authority on the law of Agency, apply the rule enunciated in Restatement §219 to fraud and deceit cases without qualification.[14] (*Gleason v. Seaboard Ry.*, 278 U.S. 349 353-354, 49 S. Ct. 161, 161-162, 73 L. Ed. 415, 417-418 (1929); *National City Bank v. Carter,* 14 F. 2d 940, 941-942 (6th Cir. 1926); *Ralston Purina Co. v. Novack,* 111 F. 2d 631, 636 (8th Cir. 1940); *Mitchell v. Union Pa-*

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means to solicit such business did not remove such solicitations from the scope of his employment.

For the exact same reason Comment *c* to Restatement of Agency §258, quoted by appellants (App. Br., p. 18) is inapposite to this case. §258 expressly provides that a principal is liable where the misrepresentations are made in connection with the subject matter entrusted to the agent (*i.e.* within the scope of his employment). The portion of Comment "c" quoted by appellants by its very terms excludes only instances where an agent makes statements concerning matters about which "the agent is not authorized to make statements". Ross as manager of the broker-dealer division was of course both actually and ostensibly authorized to speak about the subject matter of reciprocal business. [Find. 13.] (See also Comment a, §257 "If the statement is one which, if true, the agent would be authorized or apparently authorized to make, the principal is subject to liability for it although deceitfully made . . .".)

[14]The Restatement has special sections dealing with the tort of misrepresentation. (§257-264.)

Section 251 provides that a principal is liable for a servant's misrepresentations if the representation is (a) authorized, (b) apparently authorized, or (c) within the power of the agent to make for the principal. As can be seen from Comment *a* to §257 (see bottom 4 lines of footnote 13 *supra*) the words "within the power of the agent to make for the principal" closely resembles the more general formulation of the rule that the principal is liable if the misrepresentation is made within the scope of employment.

cific Railroad Co., 188 F. Supp. 869, 873 (S. D. Calif. 1960); *J. C. Millett v. Park & Tilford Distillers Corp.,* 123 F. Supp. 484, 495-496 (N.D. Calif. 1954); *Rutherford v. Rideout Bank,* 11 Cal. 2d 479, 484 (1938); *Blackburn v. Witter,* 201 Cal. App. 2d 518, 520-522 (1962); *Walsh v. Hooker & Fay,* 212 Cal. App. 2d 450, 456-457 (1963); *Ghiglione v. American Trust Co.,* 49 Cal. App. 2d 633, 637-638 (1942); *Von Schrader v. Milton,* 96 Cal. App. 192, 201-202 (1929); *Martin v. Leatham,* 22 Cal. 2d 442, 444 (1937); *Moynes v. Applebaum,* 218 Mich. 198, 187 N.W. 241, 242 (1922); Mechem, Law of Agency, §1984, p. 148 (1914).

In most of the above cases the particular transaction leading to the fraud differed radically from the usual transaction engaged in by such employees. Nevertheless, the employer was held liable.

Thus, in *Walsh v. Hooker & Fay, supra,* 212 Cal. App. 2d 450, 456-457, the registered representative employed by Hooker & Fay fradulently misrepresented a stock to a customer. The registered representative did not purchase such stock through Hooker & Fay. Instead, he purchased the stock through a broker named General American & Canadian Securities, Inc. The confirmation slip was on the latter's stationery. This procedure differed radically from all of the other transactions between Hooker & Fay and plaintiff. Nevertheless, the employer was held liable.

In *Blackburn v. Witter, supra,* 201 Cal. App. 2d at 520, 520-522, the registered representative sold plaintiff stock in a non-existent company. The customer received a different type of "receipt" than normally given by Dean Witter & Co. Moreover, the stock never ap-

peared on the monthly summary sheets mailed by Dean Witter to the plaintiff. Nevertheless, the employer was held liable.

In *Ghiglione v. American Trust Co., supra,* 49 Cal. App. 2d 633, 637-638 a manager of a branch bank represented to a customer that there were some good loans available which the bank could not take because of their long term, that the notes were adequately secured and that the bank would sell the security if the security depreciated. He further stated that such loans would give the customer an opportunity to earn 6% rather than 2%. The "giving-up" of loans by a bank was not customary. Nevertheless, the bank was held liable.

In *J. C. Millet & Co. v. Park & Tilford Distillers Corp., supra,* 123 F. Supp. 484, 495-496, an employee of the defendant attempted to obtain plaintiff's consent to act as a local distributor for defendant. Plaintiff attempted to get a no-cancellation clause but was refused. A non-cancellation clause was not customary in the industry. Plaintiff accepted the distributorship on the basis of the employee's oral representation that defendant had never in its history cancelled a distributor. This representation was false. The employer was nevertheless held liable. The court stated:

> "Park & Tilford would be liable for Cooperman's fraud only if he was acting within the scope of his employment. In a very real sense Cooperman's authority did not extend to making the fraudulent statements but that is not required. The question is whether the statements were made *in relation to the subject matter or business dealing in which the agent had authority.* The principal is liable for placing his agent in a position which enables the

> agent while apparently acting within the scope of his authority to commit a fraud. Here Cooperman's authority as Western Sales Manager, extended to negotiating with and obtaining distributors for the Company. Even though he had no final authority in their ultimate selection, obtaining the distributor's consent to take on Park & Tilford's products was clearly within his authority. Millett reasonably so understood it. The representations went to the heart of this function. Park & Tilford is liable." (Emphasis added, *Id.* at 495-496.)

In the instant case the fraudulent representations of Ross were of course made in relation to the subject matter or business dealings in which the agent had authority. Ross and Grossinger were hired primarily for the purpose of soliciting listed business on behalf of Kamen & Co. from broker-dealers throughout the United States. Obtaining the consent of such broker-dealers to give their listed business to Kamen & Co. was clearly within Ross's actual authority. Moreover, Ross had actual authority to give up legitimate over-the-counter trades [Find. 13] "If the statement is one which if true, the agent would be authorized or apparently authorized to make, the principal is subject to liability for it although deceitfully made. . . ." (Restatement of Agency 2d, §257, Comment *a*.

Even in the absence of such authority Ross' actions were within the scope of his employment. Appellants admit that, in order to procure broker-dealers' listed business, it authorized Ross and Grossinger to phone

broker-dealers and offer them what Mr. Kamen thought were valuable research services and telephonic privileges. Ross, however, apparently deeming such services and privileges insufficient to obtain such listed business, offered more; he also offered reciprocal business which, unknown to the broker-dealers he had fraudulently created. The scope of an employee's employment encompasses not only acts actually authorized by the employer but encompasses also forbidden and tortious acts which are employed by the employee in order to accomplish the result for which he was employed. The Restatement of Agency states the rule as follows:

> "§230. Forbidden acts
>
> An act, although forbidden, or done in a forbidden manner, may be within the scope of employment."
>
> "§231. Criminal or Tortious Acts
>
> An act may be within the scope of employment although consciously criminal or tortious."

Thus in *Martin v. Leatham, supra,* 22 Cal. App. 2d at 444-445, the court stated:

> "'It is the general doctrine of the law, as it is our statutory rule, that a principal is liable to third parties not only for the negligence of its agent in the transaction of the business of the agency, but likewise for the frauds, torts or other wrongful acts committed by such agent in and as part of the transaction of such business. (Story on Agency, sec. 452; Shearman & Redfield on Negligence, sec. 65; Civ. Code, sec. 2338.)'". . .

'The rule is elementary that a master is responsible for the acts of his servant done in the course of his employment, even though those acts be unauthorized or contrary to the master's explicit instructions. As between the master and third persons, the acts of the servant done as a part of the doing of that which he is employed to do are as it done by the master himself, *and the question of authority* as between the master and servant to do the particular acts is quite immaterial.' "

Likewise, in *Moynes v. Applebaum, supra,* 187 N.W. at 242, the court stated:

". . . The main question raised by defendants' counsel is the right of plaintiffs to recover from defendants in an action of fraud and deceit for the fraudulent representations of their agents where defendants had no knowledge of such representations and such representations were not authorized by them. We are persuaded that this court has settled this question adversely to the contention of defendants' counsel. . . . The son, Harry, was the agent of his father in making the sale. In selling the property he was acting within the scope of his authority. In making the sale he made certain representations. These were the instrumentalities used by him in his principal's business and for his principal's benefit, and they thereby became the instrumentalities of the principal. He cannot reap the harvest and refuse to pay for the seed."

III.

A Victim of a Fraud Which Involves the Successful Victimization of a Number of Persons Arranged in a Chain Transaction Is Not Required to Proceed Against the Prospective Victim Following Him in the Chain Before Proceeding Against the Persons Perpetrating Such Fraud.

Appellants contend that before appellee may proceed either against Kamen & Co. or against Ross and Grossinger[15] he must first proceed against the persons who were fraudulently induced to buy the stock from appellee. This is undoubtedly the first case in history where a defrauding party has come into court and stated "you have not been damaged because by repeating my fraudulent acts I can (or have) found you a buyer." Under this theory, all of the defrauded parties would sue each other while Kamen & Co., Ross and Grossinger watched and smiled.

It goes without saying that this is not the law. Defendants cite the case of *Gulke v. Brock,* 222 Cal. App. 2d 459, 460 (1963) for the proposition that "naturally, where plaintiff has been induced by fraud to purchase stock or other property but has sold or can sell that property for a sum in excess of or at least equal to the amount to be paid, he can recover no damages from the defendant." (App. Br. p. 31.) This case merely states the California "out-of-pocket" damages rule which provides that a defrauded party can only recover the difference between the price paid and the *actual value* of the property received. In that case an appraisal

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[15]Appellants' argument that appellee has not suffered any damage would of course apply equally to the liability of Ross & Grossinger.

showed that the value of the property received equalled the purchase price.

If a defrauded party resells the property purchased by him, such sale would be evidence of the actual value or the fair market value of the property but it would not be conclusive as to either such values. (*Chicago Corp. v. Munds,* 172 Atl. 452 (Del. 1934).)

The very cases cited by defendants support the foregoing rule. Thus, in *Freeman v. F. P. Harbaugh Co.,* 114 Minn. 283, 130 N.W. 1110 (1911), the court held that plaintiff's damages were *not* the difference between what plaintiff paid for certain notes and the sale price of such notes when plaintiff later disposed of them. The court stated that the sale price was only evidence of the market value of the notes and that the correct measure of damage was the price paid by plaintiff for the notes minus the market value thereof. Of course, in considering market value, the solvency of the maker and the property securing the notes must be considered.[16]

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[16]The remaining cases cited by appellants are distinguishable on the same basis. Thus in *American Nat. Bank v. Hammond,* 25 Colo. 367 (1898) plaintiff was induced to sell merchandise to an insolvent purchaser by reason of the misrepresentation of a bank employee. The plaintiff sued the bank. The court held that plaintiff's damages was the market value of the goods, minus the amount of cash plaintiff had actually received from the purchaser for the merchandise. Plaintiff's damages were not reduced by the value of any cause of action against the purchaser.

Likewise in *Hamlin v. Abell,* 120 Mo. 188, 25 S.W. 516 (1893), the court ruled that evidence of the insolvency of an endorser of a note was properly admitted to show damage to plaintiff who was induced to purchase such notes by fraudulent representation of defendant. Again, this is consistent with establishing the market value of a note. The only way one can determine the value of a note is to look to the likelihood of being paid by the maker or endorser.

In this case plaintiff has proved that the market existing at the time of plaintiff's aborted sales was manipulated. Appellants stipulated that after the manipulation ceased, the stock was worthless. Under such circumstances the evidentiary value of appellee's sales is equal to the stipulated value of the shares, *zero.*

Appellee does not, however, desire to deprive Kamen & Co. either of the Jerome Richard stock now owned by it or of its cause of action against the purchasers. Consequently it has deposited both the stock certificates and an assignment of its causes of action, if any, with the court. [R. T. 365, 461.] Appellee hereby agrees that appellants may withdraw these papers upon satisfying the judgments against them.

IV.

A Member of the Securities Industry Has a Non-Delegable Duty to All With Whom He Deals to Deal Honesty and Fairly.

Regardless of any question of the scope of Ross's employment, or the apparent authority vested in him, Kamen & Co. is liable because as a licensed broker-dealer under the Exchange Act of 1934, it was under a non-delegable duty not to violate any of the provisions of the Securities Exchange Act of 1934, either through its employees or otherwise. (Rest. of Agency §214; *United States v. Armour & Co.,* 168 F. 2d 342, 343-344 (3rd Cir. 1948); *Hudson v. Nixon,* 57 Cal. 2d 482, 484 (1962); *Snyder v. Southern Cal. Edison Co.,* 44 Cal. 2d 793, 798-799 (1955); *Taylor v. Oakland Scavenger Co.,* 17 Cal. 2d 594, 604 (1941); *Luce v. Holloway,* 156 Cal. 162, 163-166 (1909).

Restatement of Agency §214 states:

> "Failure of Principal to Perform Non-delegable Duty. A master or other principal who is under a duty to provide protection for or to have care used to protect others or their property and who confides the performance of such duty to a servant or other person is subject to liability to such others for harm caused to them by the failure of such agent to perform the duty."

Comment b. thereunder provides, in part,

> "*Action illegal unless licensed.* When a license is required for the performance of acts, one having a license who delegates performance of the acts to another is subject to liability for the negligence of the other . . ."

Comment e. thereunder provides,

> "*Voluntary relations.* A master or other principal may be in such relation to another that he has a duty to protect, or to see that due care is used to protect, such other from harm although not caused by an enterprise which has been initiated by the master or by things owned or possessed by him. This duty may be created by contract, as where one agrees to protect another, or may be imposed by law as incident to a relation voluntarily entered into, as the relation of carrier and passenger, or by statute. A statement of the situations in which a duty of this sort exists and of the limits of such duty is beyond the scope of the Restatement of this Subject. In situations coming within the rule stated in this Section, the fact that the one to whom the performance of the duty is

> delegated acts for his own purposes and with no intent to benefit the principal or master is immaterial."

Thus, in *Hudson v. Nixon, supra,* 57 Cal. 2d at 484, the court held the principal liable for her agent's violation of the Hawkins Civil Rights law without any showing of authority or personal fault of the principal. Likewise, in *Snyder v. Southern Cal. Edison Co., supra,* 44 Cal. 2d at 798-799 a public utility was held liable for an *independent contractor's* negligence in installing power poles on the principle that the installation of such poles, according to law, is a non-delegable duty imposed on the utility. In *Taylor v. Oakland Scavenger Co., supra,* 17 Cal. 2d at 604 (1941) the court also held the defendant liable for the negligence of an independent contractor. The court stated:

> "If, however, an individual or corporation undertakes to carry on an activity involving possible danger to the public under a license or franchise granted by public authority subject to certain obligations or liabilities imposed by the public authority, these liabilities may not be evaded by delegating performance to an independent contractor. The original contractor remains subject to liability for harm caused by the negligence of the independent contractor employed to do the work." (Accord *Luce v. Holloway, supra,* 156 Cal. 162, 163-169 (1909).)

In *United States v. Armour & Co., supra,* 168 F. 2d at 343-344, the court expressed the rule as follows:

> "It appears that appellant's main office had repeatedly cautioned against such conduct, but this corporation, one extremely large in the vital food in-

dustry, cannot evade its responsibility by referring to its elaborate interbranch correspondence and its instruction meetings. Seventeen violations of the tie-in sales prohibition in three out of a total of five branch houses in the Philadelphia area point to a condition prevailing of which it was the employer's duty to be aware. The checking and elimination of such obviously illegal practices is not shown to have been any more difficult than other details of a nation-wide industry. The employer 'does not rid himself of that duty because the extent of the business may preclude his personal supervision, and compel reliance on subordinates. *He must then stand or fall with those whom he selects to act for him.* He is in the same plight, if they are delinquent, as if he had failed to abate a nuisance on his land. * * * *It is not an instance of respondeat superior. It is the case of the non-performance of a nondelegable duty.*'" (Emphasis ours.)

Kamen & Co. was required to obtain a license before being permitted to engage in the business of a security broker. (Securities Exchange Act of 1934, § 15(a), 15 U.S.C.A., § 780(a).) The whole purpose and design of the Securities Act of 1933 and the Securities Exchange Act of 1934 was to protect investors against the fraudulent conduct that was rampant in the securities industry. The industry at that time was deemed to create a severe risk to the general public. (Securities Exchange Act of 1934, §2, 15 U.S.C.A. 78(b).)

The business conduct of a broker-dealer therefore comes squarely within the above-cited cases. There is imposed on each broker-dealer a non-delegable duty to

prevent a violation of the Securities Act of 1933 and the Securities Exchange Act of 1934 in any business dealings in which his firm takes part. The liability of a broker whose employees violate the Acts is not a vicarious one, it is imposed directly on the broker because of the duty imposed upon him to protect the public.

V.

The Standard of Care Imposed by the Trial Court on New York Stock Exchange Member Firms for the Supervision of Their Employees Failed to Conform to Current Standards and Is Reminiscent of a Rejected Era in the Securities Industry.

Restatement of Agency § 219(2)(b) provides:

> "A master is not subject to liability for the torts of his servants acting outside the scope of their employment unless
>
> (b) the master was negligent. . . ."

The broker-dealer division of Kamen & Co. earned more commissions during its operations than all of the other employees and all of the partners combined. At the time these commissions were being generated by Ross, there was a general custom in the securities industry which provided for the exchange of "give up" or "reciprocal business" for listed commission business. Yet Mr. Kamen bought the incredible story that Ross, with less than 18 months in the securities business, could obtain the listed business controlled by over-the-counter dealers without giving any reciprocal business. Mr. Townsend stated he would not buy such a story. [R. T. 362.] Mr. Kamen, however, not only bought the story but also accepted Ross' word that he could bring

in considerably more business than all of the eight long-time employees and two partners of Kamen & Co. combined. Moreover, he accepted Ross' word that this could be accomplished by providing such services as collect long distance phone calls for quotations on stocks[17] and furnishing Carl Loeb, Rhoades research material. Mr. Townsend and Mr. Bailey stated that the research bulletins were readily available [R. T. 295, 340] and Mr. Bailey testified that to call collect to New York to obtain the price of a stock is an "especially poor" service and would be "impossible." [R. T. 245, 300.]

What were the duties imposed by the Securities Act on Kamen & Co. at this juncture? Did Kamen & Co.'s duties at the very least require the company to appoint a partner or supervisory employee to work with Mr. Ross on this very important project or to place a partner or other supervisory employer in close proximity to Mr. Ross while he was soliciting the over-the-counter business? Such an employee sitting next to Mr. Ross in the one room occupied by Kamen & Co. in the early part of 1963 could have overheard the Jerome, Richard "give-ups" even though Mr. Kamen, separated by a banister, was not able to do so. Likewise, a partner or supervisory employee with a desk in Ross' special room could have prevented the fraud here involved. The Securities Act of 1933, the Securities Exchange Act of 1934 and the common law clearly impose that much responsibility on a firm which is a member of the New York Stock Exchange and the National Association of Securities Dealers. If the vastly reduced standards ob-

[17]Mr. Kamen admitted that brokers frequently have direct lines to New York Stock Exchange firms located in their city and Mr. Bailey testified that it would be extremely rare for a broker-dealer not to have such a direct line. [R. T. 253, 298.]

viously applied by the trial court are all that are required the responsible members of the securities industry will be able to avoid liability for their employees' frauds, no matter how much they benefited therefrom and no matter how much such fraud required the use of the members' facilities and the members' association with the New York Stock Exchange or National Association of Securities Dealers. Such liability could be avoided by the member as long as he is not actually involved in the fraud and can escape knowledge thereof for a period as long as seven months. Such standard of care will revert the securities industry to the jungle of a bygone era.

VI.

The Trial Court Erred in Refusing to Admit the Certified Affidavit of Francis J. Donnelly.

At the trial, appellee requested that plaintiff's Exhibit 52, an affidavit by an S.E.C. investigator regarding his investigation into the Jerome Richard's fraud be admitted into evidence. That affidavit contained a complete history and description of the fraud including its vast scope and the number of victims involved. The affidavit stated that more than 100 broker-dealers took part in the reciprocal business transactions (Paragraph 19), moreover, the affidavit contained the important statement that when Thomas S. Crowe, a broker-dealer located in New York, complained to Mr. Kamen that he was not getting enough reciprocal business, Mr. Kamen stated to Crowe that he would "speak to the boys about it" (Paragraph 39). Much of the information in the affidavit was obtained by the Securities and Exchange Commission by inspection of

books, records, and other documents. Of course the aforementioned statement by Kamen was obtained through an interview of Mr. Crowe. The trial court refused to admit the affidavit [R. T. 549]. It even refused to read the affidavit in order to exercise its discretion on whether to admit the document. [R. T. 547].

The affidavit was prepared by Mr. Donnelly, an investigator for the S.E.C. pursuant to the statutory obligation of the Securities and Exchange Commission to investigate possible violations of the Securities Act of 1933 and the Securities Exchange Act of 1934 (15 U.S.C.A. §§78(a) and 78(u); *Schmidt v. United States*, 198 F.2d 34 (7th Cir. 1952); *Boehm v. United States*, 123 F.2d 791, 801 (8th Cir. 1941).

Rule 515 of the American Law Institute

Model Code of Evidence provides:

> "Rule 515. Written Statements by Public Officials.
>
> Subject to Rule 519, evidence of a writing made as a record, report or memorandum of facts and conclusions concerning an act, event or condition, unless specifically priviledged from disclosure by a statute requiring it to be made, is admissible as tending to prove the truth of the matter stated therein if the judge finds that
>
> (a) the writing was made in the performance of the functions of his office by an official of a state or nation or governmental division thereof, acting personally or through his subordinates, and

(b) it was a function of the official acting personally or through his subordinates

(i) to do the act, or

(ii) to observe the act, event or condition, or

(iii) to investigate the facts concerning the act, event or condition and to make findings or draw conclusions about it."

The comments to such Rule state:

"a. Comparison with existing law. This Rule goes beyond the common law, for it admits statements as to matters not within the knowledge of the reporter or of the recorder. . . ."

This Rule is accepted by the 2nd, 6th, 3rd and 10th Circuits. (*E. K. Hardison Seed Co. v. Jones*, 149 F.2d 242, 256-257 (6th Cir. 1945) [expressly holding that the results of an officer's investigation are admissible even though the officer does not have first-hand knowledge of the facts]; *Pittsburgh-Des Moines Steel Co.*, 183 F.2d 467, 473 (3rd Cir. 1950) [holding that the inclusion of hearsay in report goes to the weight, not the admissibility of such report]; *Hunter v. Derby Foods*, 110 F.2d 970, 972-973 (2nd Cir. 1940); *Franklin v. Skelly Oil Co.*, 141 F.2d 568, 572 (10th Cir. 1944) [investigative document of fire marshal held admissible but trial court did not abuse its discretion in refusing to admit the document].

In *Oleander v. United States*, 210 F.2d 795, 800 (9th Cir. 1954) this court apparently rejecting the Model Code of Evidence and the authorities cited above,

made a distinction between official records where the author had personal knowledge of the facts and official records where such knowledge was obtained by investigation. The court stated that the latter documents were not admissible. The *Oleander* case has been sapped of much of its vitality by *Canada Life Assurance Company v. Houston,* 241 F.2d 523 (9th Cir. 1957). (See also: *LaPorte v. United States,* 300 F.2d 878, 881 (9th Cir. 1962).) Thus in *Canada Life Assurance Company v. Houston, supra,* this Court held that the verdict of a coroner's jury, clearly a document where the authors did not have first-hand knowledge of the facts, was admissible evidence.

The affidavit of Francis J. Donnelly was prepared by an impartial official, in the exercise of his official duty. These attributes alone would normally be enough to render the document sufficiently trustworthy to permit its admission into evidence. The affidavit of Mr. Donnelly, however, was also under oath therefore adding this additional safeguard. Had the trial court admitted Exhibit 52, it would have obtained the important information concerning the conversation between Crowe and Kamen which clearly indicates that Kamen well knew that his employees were giving reciprocal business of some nature even if he did not know the exact nature of the fraud being perpetrated. Mr. Kamen, of course, would also have had to know that the business was artificially generated since he testified that he had very little over-the-counter business. [R. T. 256.]

The affidavit also contained a large amount of information gathered by Mr. Donnelly first hand. For example the number of brokers involved [¶ 19] (bearing upon the reasonableness of the reliance), the fact

that part of the commission of Ross and Grossinger were shared with Perotta and Ginsberg [¶ 16][18] as well as other important investigatory information such as the extended presence of Herman at Kamen & Co.'s office even though Herman was not an employee. [¶ 19.]

The trial court's failure to admit this affidavit or at least to exercise its discretion[19] as to whether such document should be wholly or partially admitted was error.

Respectfully submitted,

Rosenfeld, Meyer & Susman,
Gary A. Schlessinger,
Attorneys for Appellee.

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[18]The payment of part of the commissions of Ross and Grossinger to Perotta and Ginsberg, who were not registered representatives of course violates the New York Stock Exchange anti-rebate rule.

[19]The trial court did not exclude the report in the exercise of its discretion, since it refused even to read the report [R. T. 547.]

Certificate.

I certify that in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Gary A. Schlessinger

APPENDIX A.

"EXCERPTS FROM REPORT OF SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION, PART 2".

2. STRUCTURAL ASPECTS OF THE PUBLIC RATE SCHEDULE

This section singles out certain aspects of the structure of the public or nonmember commission rate schedule because of their distinctive repercussions not only upon public customers but also on professionals in the securities business who are not members of the NYSE, on the regional exchanges and their members, and on both mutual funds and their shareholders. The next section examines structural aspects of the members' rate schedules. While these structural aspects involve issues of basic importance, many of which have been the subject of numerous studies and differences of view within the Exchange community, they have only in limited respects received the formal attention of the Commission.

a. Nonmember professionals pay the same rate as other customers

Under the public commission schedule of the NYSE, a nonmember broker must pay a member the same commission that his customer would pay if he were to place the order directly with a member. Yet the nonmember incurs, in addition to the commission cost, overhead and other expenses incident to securing and transacting the business. Since competition normally prevents the nonmember from charging his customer any more than the rate charged by a member, his gross income from the transaction generally equals the commission he pays to the member, notwithstanding his other costs. Yet unless he accepts such NYSE business placed with him by his customer, he runs the danger of losing both customer and business altogether.

Such business is important to the NYSE. Its studies conducted between 1952 and 1960 show orders from nonmember brokers to the NYSE for public individuals, institutions, and others accounting for 11 to 24.3 percent of total share volume effected for the account of

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[545] A provision of the original bill (sec. 18(c) of S. 2693, 73d Cong., 2d sess.) empowered the Commission to fix rates directly, just as it was authorized to deal directly in most of the other areas now covered by sec. 19(b). When the present machinery of sec. 19(b) was substituted, no attention appears to have been given, at least on the record, to its impact on the review of commission rates.

institutions and intermediaries, which during this period represented about 20 percent of the Exchange's total volume.[546] Such transactions at full commission rates are obviously profitable to the NYSE member, and there is incentive for him to make it attractive for the nonmember professional to forward it to him. But the constitution of the Exchange provides that commissions paid to the member shall be—

> * * * net and free from any rebate, return, discount or allowance made in any shape or manner, or by any method or arrangement, direct or indirect.[547]

Member and nonmember must then devise some other means of both reimbursing the nonmember and attracting the business to the member. Attempts to bypass this NYSE antirebate provision have been the single most important cause of the development of what are generally referred to as "reciprocal business arrangements" and "special" services among member and nonmember firms.

(1) *Reciprocal business arrangements*

The member desiring to reciprocate for commission business given him by a nonmember professional can do so by returning commission business to the nonmember. There are several methods, only the most important of which can be mentioned here: he may place business on a regional exchange with a nonmember who is a member of that exchange even though (a) the member is also a member of the regional exchange (dual member) and could have placed the business there directly or (b) the security is traded on the NYSE as well as the regional exchange (dual listing) so that the dual member could have effected the transaction directly on the NYSE. He may place orders for unlisted securities with the nonmember to be transacted over the counter, even though the member firm may have a trading department capable of effecting the transaction directly. This reciprocal commission business is generally placed under arrangements involving "reciprocal ratios" of 2 to 1, 3 to 1 or similar ratios; that is, the NYSE member will direct $1 in commissions to the nonmember for each $1.50, $2, or $3 of commissions received.[548] The ratio always favors the NYSE member.[549]

A variation of the basic type of reciprocal commission arrangement is cited in the testimony taken by the Special Study of a partner in a member firm of both the NYSE and the Philadelphia-Baltimore-Washington Exchange and himself an active specialist on the latter exchange. Many of the firms which are members of the regional exchange but not of the NYSE give this firm orders to execute on the NYSE. When asked what his firm gives, by way of reciprocity, to such regional members, the partner answered:

> A. We eventually will give that man clearance[550] to the extent, we will say, of roughly 50 percent. It would not be in excess of that. That will net him about 40 percent, after he pays floor brokerage and clearance charges.
>
> Q. What kind of clearance business will you give him? Where will it come from?
>
> A. If Laird, Bissell & Meeds [an NYSE member firm] will sell us 500 General Motors, instead of giving up our name on the transaction we will give up the name of a local member to whom we wish to give clearance business.

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546 NYSE, "Ninth Public Transaction Study," p. 11 (1959) ; "Tenth Public Transaction Study, Pt. II," p. 10 (1960).

547 NYSE constitution, art. XV, sec. 1.

548 See pt. E of ch. VIII.

549 Apparently as a result of reciprocal arrangements of all kinds, one nonmember firm advised the study that despite the antirebate provisions of the NYSE constitution the firm ultimately receives in return the equivalent of approximately 40 percent of the commission on NYSE business forwarded to member firms.

550 The term "clearance" here seemingly refers to both execution and clearance of a transaction.

If a bank, for instance, gave us 500 Pennsylvania Railroad to sell, we would give up the name of some local broker on that transaction. He would act as clearance agent on that. Therefore, it would come both from firm trading and from customer business.

Q. What is the ratio here?

A. I do not know, possibly 60 to 40; 60 percent firm and 40 percent customer, in our case. In other cases it might all be the customers.

Upon first impression, one might regard a practice such as this as typical of reciprocity in many industries in which a firm reciprocates for orders from a customer by placing business with him for goods or services it cannot provide itself. Thus, securities commission firms commonly receive brokerage business on a reciprocal basis from commercial banks in which they maintain sizable accounts.[551] There is a fundamental difference in reciprocal commission arrangements between brokers, however, because the NYSE member is generally able to handle directly, and at least as effectively, the business he places with his reciprocal partner.

The extent of these reciprocal commission arrangements is revealed in the returns to the Special Study's questionnaire EX–4. Of 447 members of the four largest regional exchanges not members of the NYSE (i.e., "sole members"), 298 reported participation in such arrangements in ratios ranging up to 3 to 1, but with 2 to 1 most popular. Of the 285 members reporting on the income received from such arrangements, 41 attributed to them at least 40 percent of their income, and 175, or 61 percent, attributed a minimum of 20 percent of their income to this source. (Tables VI–z to VI–bb.)

TABLE VI–z.—*Number of sole regional exchange members having reciprocal arrangements*

Exchange	All members	Members with reciprocal arrangements	Members with no reciprocal arrangements
Total	447	298	149
Boston	29	6	23
Midwest	233	149	84
Pacific Coast	78	59	19
Philadelphia-Baltimore	107	84	23

TABLE VI–aa.—*Nature of reciprocal arrangements of sole regional exchange members*

[Number of members]

Reciprocity ratio (regional members to NYSE members)	Exchange				
	All members	BSE	MSE	PCSE	PBSE
Total	[1] 280	5	137	57	81
1 to 1	7		3	2	2
1½ to 1	2				2
2 to 1	203	3	85	50	65
2½ to 1	36	2	28	2	4
3 to 1	32		21	3	8

[1] Excludes 18 members who have reciprocal arrangements but did not furnish complete information

[551] See ch. VIII.C.4.c.

TABLE VI-bb.—*Proportion of total exchange income received from reciprocal business by sole regional exchange members*

[Number of members]

Ratio of income from reciprocal business to total exchange income (percent)	Exchange				
	All members	BSE	MSE	PCSE	PBSE
Total	285[1]	6	139	59	81
0.1 to 10.0	52	2	19	18	13
10.1 to 20.0	58	1	28	13	16
20.1 to 30.0	88	1	45	14	28
30.1 to 40.0	46	----------	26	11	9
40.1 to 50.0	18	1	12	----------	5
50.1 to 60.0	14	----------	5	2	7
60.1 to 70.0	5	----------	2	----------	3
70.1 to 80.0	2	1	1	----------	----------
80.1 to 90.0	----------	----------	----------	----------	----------
90.1 to 100.0	2	----------	1	1	----------

[1] Excludes 13 members who engage in reciprocal business but did not furnish complete information.

Return by an NYSE member of cash to his reciprocal correspondent for commission business would violate the antirebate rule cited above, but the return of a cash equivalent in the form of profitable security commission business which might have been transacted directly by the NYSE member is permissible. The distinction is obviously a fine one and it has produced a fertile field for administrative interpretation. The Exchange's published constitution and rules have never officially recognized a need to regulate reciprocal commission arrangements. Its rule 369 outlaws 10 specific commission practices either outright or under specified conditions, but does not mention reciprocal arrangements with nonmember professionals. An NYSE interstaff memorandum illustrates that the problem is present and is a perplexing and demand one:

> In general, the Exchange does not object as a matter of policy to the existence of reciprocal arrangements, per se, even when they are based upon a ratio, such as 2 for 1, 1 for 3, etc., provided any business directed to the nonmember is bona fide business, and does not involve so-called "generated" business or "allocated" trades, and further provided any ratio is not guaranteed and no deficiency in the amount of business given by the member to the nonmember is paid or made up in cash. If a member firm has a well-organized and well-staffed department for handling, as an example, over-the-counter business, the Exchange probably would object to that firm's directing all of its over-the-counter business to a nonmember under a reciprocal arrangement.

Testimony to the Special Study by NYSE staff officials Frank Coyle and Walter Coleman served to point up the problems of interpretation. Coyle and Coleman confirmed that the first sentence in the quoted paragraph still represents the policy of the Exchange. They noted that an "allocated" trade "would be a transaction which is a bona fide trade but, as an example, might have been executed by me as a broker and I would give bookkeeping credit to someone else for having executed when in fact they would not." An example of "generated business" was given by Coleman as "* * * a transaction which I originate as principal, not as customer. I might as a broker give you an order for which I had no particular need." Coyle defined the term as "an order created solely for the purpose of paying you a commission for executing it in a stable security where the risk is not high and where I would reverse the transaction again giving you another com-

mission." The witnesses were asked "* * * does it matter if the ratio is a firm one or not?" and the testimony proceeded as follows:

A. [By Coyle] To my way of thinking it makes no difference at all what the ratio is. If the reciprocity is merely on a business basis that I give you business because I think you can execute it, and I hope you give me business for the same reason, and we will try to keep even with each other, and so long as I have sufficient on your exchange to match what you give me on my exchange, and the rates I pay for that are proper, I see no objection to it whatever.

Q. The paragraph goes on to say that if a member firm has a well-organized and well-staffed department for handling, say for example, over-the-counter business, the Exchange probably would object to that firm directing all of its over-the-counter business to a nonmember under a reciprocal arrangement. Is that the present policy of the Exchange?

A. Well, I have got to add a little explanation with it, yes, with this explanation. By agreeing to give all your business in over-the-counter securities to one broker, you may not be servicing your customers properly because he may not properly cover the waterfront. An unlisted market is not the same as a listed market where there is a central point and policies, and records of the transaction. We think it is the duty of the broker to do the best for his customer and by promising to give all the business to one person willy-nilly might violate that.

* * * * * * *

Q. The policy refers to a "well-organized and well-staffed department." How many member firms of your Exchange meet this test, percentagewise?

A. Again you are reading from a memorandum, an interstaff memorandum, which was not written with the idea that it was going to be a legal matter for all time and it is one member of the staff telling another member of the staff in general terms broad policy. I think I would have to get a definition from you as to what you mean by a well-organized and completely staffed department to answer your question as to how many firms have them.

The complexity of the problem becomes apparent. Reciprocity arrangements representing "generated" or "allocated" business violate the antirebate rule; reciprocal business based on the member's "hope" that he can secure return business is legitimate. The arrangements referred to above actually fall somewhere between the extremes. The member normally directs business to his reciprocal correspondent with something more than "hope" that his correspondent will reciprocate. Members' reports of such agreements filed with the Midwest Exchange under its commission rules indicate the firmness of the understanding on which they are founded. This general recognition of the existence of reciprocal ratios elevates the basis of these arrangements from the level of "hope" to that of reasonable expectation based on informal agreement, often crystallized by years of business relationship and always subject to the sanction of cancellation if the correspondent fails to maintain the agreed ratio.

The NYSE's task of policing the antirebate rule in this field extends beyond its own floor. Because its members often discharge their reciprocal obligations by placing business with reciprocal correspondents for transaction on the regional exchanges, the question is presented concerning the Exchange's power to prohibit a member from engaging in a practice permissible under the rules of a regional exchange but constituting a rebate under its own rules.

A prime example of this conflict is the problem discussed at a Toronto meeting of top officers of the NYSE and the presidents of some of the regional exchanges in October 1952. At issue was the question of the amount of the commission to be paid by a dual member to a regional-only member on reciprocal business. At that time most of the regional exchanges either provided that the member "execu-

tion and clearance" commissions might be "mutually agreed" between members of the particular exchange, or else prescribed minimum rates of 25 percent of the nonmember rates. Dual members, however, were voluntarily paying more than 25 percent for the execution and clearance of business which they directed to regional members in return for NYSE orders received from such members. In many cases they paid the full nonmember rate.

Although such practices were permissible under the rules of the regional exchanges, the NYSE opposed them, arguing that, as a member of the regional exchange, the NYSE dual member was entitled to execution and clearance at the regional member rate of 25 percent, and any payment in excess of that figure constituted a rebate of commissions received on NYSE business placed with him by the regional member. The regional exchanges initially emphasized their exclusive jurisdiction in setting their own internal rates. The Toronto meeting resulted in a compromise arrangement under which most of the regional exchanges either increased their minimum execution and clearance commission to 50 percent of the nonmember rate, or continued to allow each member to set his own execution and clearance rate, with an understanding in both cases that no dual member would be charged more than 50 percent of the nonmember rate if he did any NYSE business with the regional member. This compromise was described in an NYSE memorandum as " * * * an informal but nonetheless binding commitment to us * * * " that the regional exchanges would not permit dual members engaged in reciprocal business with regional members to pay "anything in excess of 50 percent of the full nonmember rate."

At first the Boston (BSE), Pittsburgh, and Cincinnati exchanges refused to accept this arrangement, but by 1954 only Boston remained as a holdout. The BSE's position caused the NYSE considerable embarrassment, as interoffice memorandums and correspondence reveal. The matter was apparently formally closed in May 1962, when Boston apparently finally accepted the 50-percent arrangement.

Coyle was asked to explain the basis for the acceptance of the 50-percent rate as a dividing line between permissible commissions and rebates.

Q. Did your department inquire into whether the 50 percent represented a reasonable compensation for [execution and clearance]?

A. Yes.

Q. What was the conclusion?

A. The conclusion was that we were leaning over a little bit to accept that as the reasonable cost of doing such business.

Q. Well, was this 50 percent a negotiated figure between your Exchange and regional exchanges?

A. I don't know.

Q. Well, under what circumstances did you make such a study or give consideration as to whether 50 percent was a reasonable arrangement?

A. Well we related it to the known arrangements on our own Exchange where out-of-town member firms, correspondents of New York firms, had such work done for them and a great deal more, including the transportation of business from out-of-town to New York on a costly private wire, and that they were doing that for, as I said, from 27 to 40 percent.

Q. But here the local member on the regional Exchange is receiving 50 percent without providing any of the services which were in fact being borne by the New York member?

A. That's right.

Q. So that the 50 percent then would represent more of a difference between 40 and 50 percent than would appear on the surface?

A. That's right.

* * * * * * *

Q. Was it your judgment that this did or did not involve a rebate, this 50-percent figure?

A. I wouldn't say it involved a rebate. I think it showed the development of a loophole by which the donors of New York Stock Exchange business could find an avenue of return income within and with the help of rules of other exchanges of which they were members.

Q. Was it your judgment that they have successfully found such a loophole?

A. I don't think I have an opinion.

Q. Well, you do agree that the 50-percent figure [when considered], with the other services [provided by the dual member for the nonmember firm], is far in excess of the [execution and clearance] figures that prevail on your own floor.

A. Obviously.

The drive to circumvent the strict terms of the NYSE nonmember commission rate schedule may be illustrated by another practice known as a reverse transaction. In this situation the NYSE member seeks to reward the nonmember for business received not by returning commission business but by effecting the nonmember's transaction at a cost less than the commission rate. One form of this practice is set forth in an Exchange memorandum outlining a so-called arbitrage operation which involved the NYSE and the Midwest Stock Exchange.

Mr. Thomas Kohler, a specialist on the Midwest Stock Exchange, who also acts as floor broker for Scherck, Richter & Co., sits right next to the teletype machine of [the NYSE member firm of] Vilas & Hickey on the Midwest floor. Other specialists who want to buy stock on the NYSE to offset their specialists positions go to Mr. Kohler if he is available, and merely say "buy 100 Steel" or something comparable, and it is tacitly understood that Mr. Kohler will give that order to the Vilas & Hickey telephone operator, who transmits it to New York. Vilas & Hickey buys for its own account on the NYSE 100 shares of Steel, or whatever the order calls for, and wires back, via the teletype wire to the Midwest floor, instruction to sell the same stock to the Midwest specialist who placed the original buy order. In the case of low or medium priced stocks, this is done at an automatic markup of ⅛ point over the actual cost on the NYSE. In the case of some high-priced stocks, the markup is ¼ point.

In a few cases, when the Midwest specialist introduces his buy order through Kohler, or in Kohler's absence, directly with the teletype operator of Vilas & Hickey, a price is specified. In most cases, however, no price is specified and it is tacitly understood that Vilas & Hickey will buy for its own account at the market in New York and sell on the Midwest at a markup of ⅛ or ¼ point.

It is very fast wire, and according to Mr. Hosty there is a steady stream of orders going over the wire all day long. Further, according to Mr. Hosty, practically everyone on the Midwest Exchange knows that the purpose of the arrangement is not to conduct an arbitrage, but, rather, to enable specialists and floor traders or floor brokers on the Midwest Exchange to get New York executions for less than the nonmember commission.

The NYSE required the member firms involved to discontinue the practice and subsequently denied a request by the Midwest Stock Exchange to allow the practice. Its occurrence demonstrates, however, the motivations created by a commission schedule which treats essential business transactions of nonmember professionals in the security commission business the same as ordinary transactions of the public generally.

(2) *Special services arrangements*

Subject to the vaguely adumbrated exceptions discussed above, the NYSE member may thus reward a nonmember professional for securities business by reciprocating commission business on an agreed

ratio without violating the antirebate rule. He may also accomplish the same objective, within certain limitations, by furnishing his correspondent with special services: installation and maintenance of wire services,[552] clearance of non-Exchange transactions,[553] office space,[554] special research, and promotional materials and displays.[555]

Once more the interpretation is a delicate one. Section 2.c, below, describes how the nonmember commission rate covers many services incident to the brokerage business in addition to the execution and clearance of a transaction. Most of these services for public customers are generally not required by a professional in the securities business. But because the nonmember professional receives no discount under the existing nonmember schedule, the NYSE member can correct this apparent inequity and, at the same time, tangibly acknowledge his appreciation for securities business directed to him by furnishing the nonmember with special services he does need.

Consistent application of the antirebate rule would seem to require an interpretation prohibiting special services costing more than services rendered to other customers generally. Once again the distinction poses some fine administrative questions. They may be illustrated by the practice of maintaining private wires between the offices of a member and nonmember in order to service the nonmember's business transacted with the member. The practice is generally permissible, but where the nonmember also uses the wires for communication with his own branch offices or with another nonmember, the rules require him to contribute toward the cost "in proportion to his use thereof with a minimum of 10 percent." This refinement aside, a member may incur unlimited expense in maintaining such wires as long as they are used to service the nonmember's business with the member. It would, however, be a rare coincidence if the cost of such wires turned out to approximate the cost of value of normal services to investors generally included in the commission rate.

Another special service of NYSE members to nonmember professional customers is the clearance without charge of nonexchange transactions. Although the NYSE does not purport to prescribe commissions for such transactions, the Exchange has interpreted the "no rebate" provision to prevent members from reciprocating for security commission business on the NYSE by clearing regional exchange or over-the-counter transactions free of charge. The problem again proved vexing, however, when the Exchange's interpretation of the antirebate rule collided with a regional exchange's application of its own commission rules. An NYSE departmental memorandum of March 1954 noted that dual NYSE-Boston members with clearing facilities in Boston were clearing BSE transactions for BSE members free of charge in return for NYSE business received from such BSE members. It added that "Mr. Besse, president of the Boston Stock Exchange, has told us that this has been standard practice for the past 30 years." No action was taken on the matter until 1960, when Coyle, in a memorandum to NYSE President Funston, noted in part:

> In the Philadelphia, Chicago, and West Coast Exchanges our members make charges for handling any clearance business for specialists on those exchanges.

[552] NYSE rule 359; NYSE Guide, par. No. 2359.10.
[553] NYSE Guide, par. No. 2381.18.
[554] NYSE rule 344; NYSE Guide, par. No. 2344.11.
[555] NYSE Guide, par. No. 2440A. See ch. XI.

The charges are not uniform in all the regional exchanges, but they are based on a per-share item charge. In Boston, however, for many years a few member firms have not charged anything at all for clearing transactions—primarily odd lots—for certain Boston specialists.

We propose to tell each of the member firms in Boston presently doing such clearance on a "love" [free] basis that the Exchange expects that some charge be made—a per-share charge that will at least cover out-of-pocket expenses. This is entirely consistent with our decisions over the years not to permit any firm to rebate commissions on listed business effectively by doing other business for nothing. Each of the member firms involved receive listed NYSE business on which full nonmember commissions are charged.

The Exchange then advised some of the firms involved in the practice that "* * * we believe that the free clearing of such transactions is contrary to the spirit of our 'commission law' " and that the Exchange "expects" member firms to charge a per-share rate "that will at least cover out-of-pocket expenses for handling such business." The Boston exchange complied with this request, but after discussion with the NYSE, it was agreed that the charge be fixed at 25 cents per item rather than on a per-share basis.

When asked whether his department made any study to determine whether the 25-cent-per-item charge was compensatory, Coyle stated simply, "No, we did not." This 25-cent rate applied to the clearance of each odd-lot order would appear to be far lower than the NYSE clearance charge on agency transactions of 75 cents to $5 per 100 shares, depending on the price of the stock.[556] The resolution of this rebate problem appears to have followed the same pattern as the 50-percent compromise discussed above: a nominal charge converted a prohibited rebate into a permissible arrangement.

(3) *Some consequences of the arrangements*

When the various reciprocal business arrangements and special services have been described, it may be proper to ask whether the inflexibility of the present schedule which gives rise to them constitutes a real problem after all. Do not these arrangements and services informally achieve salutary results? In answering this question, consideration must be given to collateral consequences in terms of difficulties of administration, possible conflicts of interest, distortion of costs, and impact on regional exchanges.

The administrative involvements alone might be considered a sufficient answer to the question.[557] A complex system of arrangements designed to circumvent the strict prohibitions of an antirebate provision would not seem to be a desirable answer to a pricing problem in any industry, even apart from the fact that the Commission is called upon to grant its blessing to such practices, at least tacitly, by approving the commission schedule which begets them.

The possible conflicts of interest arise from the fact that the member's desire to provide reciprocal business to the nonmember professional is likely to exert some influence upon the member to place orders with his reciprocal correspondent in order to fulfill his com-

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[556] See table VI-x, p. 298, above.

[557] As early as 1940, a special committee of the NYSE referred to reciprocal business and special service arrangements as a "highly controversial subject":

"No split of commissions with non-members is recommended at this time. But it is recommended that the highly controversial subject of reciprocal business, payment for facilities such as wires, office facilities and the like, all of which have a definite bearing upon commission splits between members, be studied later by a committee appointed as a subcommittee of the Committee on Member Firms."

No record of any such study could be found in the Commission's files.

mitments according to an agreed ratio, rather than transacting all his business in the best available market. Even the member who steadfastly resists this pressure would surely be less vulnerable to criticism or question in the absence of such possible conflicts of interest.

These arrangements also tend to complicate measurements and analysis of the costs of conducting a security commission business.[558] The NYSE Income and Expense Report for member firms provides for deduction from income of security commissions paid to others; yet this is an expense that, in the absence of a reciprocal arrangement, the member might often be able to reduce or eliminate by handling the transaction directly. The report also contemplates deduction of amounts paid for wire services, statistical and advisory services, and similar items, although these expenses cover services that may differ radically in scope from those normally performed for public customers.

A further consequence of these practices concerns the regional exchanges, which are discussed in chapter VIII.E. It has been seen that the regionals have served as an instrument for the transaction of reciprocal commission business. The arrangements have obviously created trading volume for the regionals but has made them dependent to that extent upon the maintenance by the NYSE of a unitary commission structure.

(4) *Possible courses*

A possible solution to these problems would be extension of some form of preferential treatment in the NYSE commission rate structure to nonmember professionals. This would presumably grant such nonmembers the equivalent of present rewards without the existing maze of reciprocal commission and special service arrangements.

As indicated in section 1, the Amex and three of the regional exchanges provide special treatment for the nonmember professional. As of March 1962 the Amex had 415 associates members—there is no limit on the number in this class [559]—compared with 499 regular members. They are subject to exchange discipline (although their partners are not),[560] but they do not vote on matters affecting the exchange and do not share in its liabilities.[561] Since all but 41 of the Amex's associates member firms also have full seats on the NYSE, this class of membership does not appear to have served primarily to provide access for professionals not able to afford a full seat. The Amex has recently amended its constitution to increase the number of its full memberships, apparently with the purpose of encouraging some of its associates to become full members, and at the same time making associate membership more attractive for others.[562]

In 1955, a Special Review Committee on Rules and Procedures of the NYSE investigated the status of the nonmember professional and reached the following conclusions:

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[558] The subject of measurement and analysis of cost is more broadly discussed in sec. 4, below.

[559] Amex Constitution, art. IV, sec. 1(c).

[560] The Amex has recently indicated that the subject of disciplinary controls over partners of associate members will be studied with a view to extending such controls to this group. See note 543, p. 299.

[561] Amex Constitution, art. IV, sec. 1(c); art. IV, sec. 4; art. XIII.

[562] As a result of these amendments to art. IV, sec. 1; art. VI, sec. 2; art. VII, sec. 1; and art. II, sec. 2, approximately 60 associate members elected to purchase regular memberships by the end of May 1963. All of these amendments will be wholly effective by the end of July 1963.

Existing provisions for membership in the Exchange are adequate to the needs of the security industry and the Exchange should not create associate memberships.

The committee arrived at these conclusions because it felt that the payment of any reasonable portion of the minimum commission to a nonmember would not represent an adequate inducement for the nonmember to exert effort to produce additional listed business; that any lowering of the standards or basic principles of present Exchange membership would detract from the value of the marketplace. In the opinion of the committee nonmembers who wish to participate in the Exchange business should join the Exchange membership either as partnerships or corporations and contribute directly to the marketplace.[563]

This position was endorsed by the Special Committee on Member Firms Costs and Revenues in 1958. The supplementary report of this committee stated:

The committee found no reason to recommend splitting commissions with nonmembers. Qualified individuals or firms willing to participate in Exchange commission business should join the membership, submit to Exchange regulations and contribute directly to the Exchange marketplace.

Although the first of the quoted reports was made public by the Exchange, it appears that the Commission's review of rate changes on various occasions, as discussed in section 4, did not involve consideration of this aspect of the rate structure. It is clear that the problem warrants further study with active Commission participation. The general objective would be to consider the feasibility and advisability of formulating a special rate or limited membership so that the return received by a nonmember broker-dealer for placing NYSE business would be broadly equivalent to his return under the present system of reciprocal business and special service arrangements. Depending on the details, a probable result of such a change might be a loss in volume of trading on the regional exchanges—an effect requiring candid appreciation and analysis. Thus, one of the questions meriting further study is whether and how the needed flexibility may be introduced into the NYSE commission structure without causing irreparable harm to the regional exchanges.

"EXCERPTS FROM PART 4 OF REPORT OF SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION."

b. The impact of exchange membership

For the broker-dealer firm which has rendered services relating to a mutual fund, whether in selling its shares or in some other way, the manner in which it will be compensated for such services depends in large measure on the exchange or exchanges of which it is a member.

The problem is least complicated for members of the New York Stock Exchange. As has been suggested above, the fund, fund adviser or fund underwriter which wishes to reward a NYSE member for sales or other services can do so either directly by placing with it an order to buy or sell an NYSE-listed security on the Exchange or indirectly by instructing another NYSE member firm with which it has placed an order to give up a portion of its commission on that order to the firm to be rewarded. In the latter case the rewarded firm performs no function in connection with the execution itself. The give-up of a portion of the commission to it does not violate the Exchange's antirebate rules, which apply only to commission splitting with nonmember firms. From the point of view of the fund and its shareholders, the give-up does not involve an additional amount above the Exchange's minimum commission rate schedule, which requires that it pay the same brokerage commission for a transaction executed on the Exchange, regardless of who performs the execution or benefits from the commission.

The growth in recent years of the over-the-counter market in listed securities [257] casts a shadow of conflict on these transactions, however. If a fund makes a purchase on the NYSE of a listed security which is available as well from an over-the-counter firm on better terms, its choice of the Exchange method would be counter to the best interests of the fund and its shareholders, except in unusual situations.

For a broker-dealer which is not a member of the NYSE but is a member of a major regional exchange, the manner of its reciprocal reward is not substantially more complicated, despite the NYSE antirebate rule. The reciprocal allocation of a portion of portfolio fund brokerage to a wider circle of fund retailers is made possible by the existence of the dual trading system, whereby many NYSE-listed securities are also traded on regional exchanges, and the dual membership system, whereby a number of NYSE members also have memberships on regional exchanges. Thus to reward a broker-dealer firm which is only a member of a regional stock exchange for its sale of mutual fund shares, the fund's investment adviser may instruct a dual member to execute an order for a dually traded security on the regional exchange, and to give up a portion of its commission to the regional-only member firm. Such a give-up is consistent with the

[256] See ch. VI.I.2.b(1).

[257] See ch. VIII.D for a discussion of the over-the-counter market in exchange-listed securities.

rules of the regional exchanges; indeed three regional exchanges[258] permit commission splitting with NASD members which are not exchange members. Although the regional exchanges also have minimum commission rate schedules, which are no higher than those on the NYSE, and their executions are in large measure closely geared to executions on the NYSE, the channeling of reciprocal business through the regional exchanges can also raise questions of conflict of interest. Not only is there always the question whether better terms might be available in the over-the-counter market, but certain practices, such as the "keep in line" order,[259] can sometimes raise a question whether a given execution on the regional exchange in an NYSE stock is as favorable as what might have been obtained on the NYSE. A troublesome aspect of such a conflict of interest is the difficulty in ascertaining whether in each instance the conflict is being properly resolved in favor of the fund's shareholders.

As suggested in chapter VIII.E, reciprocal business is an important aspect of the functioning of regional exchanges. Most of the issues which they trade are also listed on the NYSE. Two-thirds of the four largest regional exchanges' "sole" members (those not members of other exchanges) reported participating in reciprocal business arrangements, and over 60 percent of these participants attributed to such arrangements one-fifth or more of their total exchange income.[260] The major single source of reciprocal business income from institutional investors to the regional exchange firms is probably mutual funds. They were, for example, responsible for $14.9 million of the total of $22.4 million in transactions executed on regional exchanges in April 1962 by the various institutional investors which reported such transactions to the Special Study; when issues listed only on regional exchanges are eliminated from the totals, funds were responsible for $14.5 out of $20.9 million in reported transactions (tables VIII–20 and VIII–20d). On a percentage basis, mutual funds reported transactions on regional exchanges in dually traded stocks in April 1962 which had an aggregate dollar value equal to 9.2 percent of the dollar value of their NYSE transactions in stocks during that period, while no other institutional investor had a percentage higher than 2.6. It would appear that funds and their managers make deliberate use of the regional exchanges in allocating their portfolio brokerage for reciprocal purposes.

For the broker-dealer firm which is not a member of any exchange, the problem of obtaining the benefit of reciprocal business "earned" through selling mutual fund shares or rendering other services is the most difficult. The problems are illustrated in an exchange of correspondence between a nonmember and the investment adviser of a fund whose shares it had sold. The dealer wrote:

> About 2 months ago Mr. [D. H.] was in our office, and at that time we inquired as to the possibility of receiving from you some reciprocal business in consideration of the business which we had done during the past year. * * * Mr. [H.] advised that, normally, whenever a firm had done at least $25,000 business a year they tried to give them some reciprocal business, and he would make it a point to see that we received some.

[258] The Pacific Coast Stock Exchange, the Detroit Stock Exchange, and the Cincinnati Stock Exchange. See ch. VI.I.1.b(2).
[259] See ch. VIII.E.4.d(1).
[260] See ch. VI.I.2.a(1) concerning the extent of sole members' dependence on reciprocal business.

In its reply the investment adviser said:

We would be delighted to place reciprocal business with your firm but since the greater part of our activity is in stocks listed on the New York Stock Exchange it is difficult to get business to a nonmember firm unless they have a correspondent or a member house that they wish to favor. Otherwise we can only wait until there is a new offering which we decide to buy and we can then ask the underwriters to include certain dealers for selling group participation, the stock of course to be taken by us.

* * * * * * *

No one has a preferred position. Sooner or later we will be able to show our appreciation of what you are doing for us. If you have any ideas or suggestions I should be pleased to hear them.

Some months later the dealer renewed its request:

It has been approximately 6 months since we first wrote to you after talking to your Field Representative, Mr. [D. H.].

We appreciate the fact that it is more difficult for you to give us reciprocal business, since we are not New York Stock Exchange members, but we had hoped that by this time there would have been some occasion in which, either through new underwritings or after market offerings, that you might have been able to throw some business our way. Your portfolio shows holdings of various unlisted stocks, so we are still hoping that you may accomplish the above.

The adviser replied:

We have your firm in mind for the first opportunity that develops where we can place your firm in a selling group in a new issue where we could be buying. Also any after-the-market offers where it can be done. We try to work out such an arrangement but quite frequently at the last minute the underwriters are unable to deliver.

I can assure you we very much appreciate your interest in our behalf and are continuing our efforts to find some way of showing this appreciation in a more concrete manner.

These letters suggest some of the problems involved in allocating funds' reciprocal business to over-the-counter dealers and some of the methods which have been used to accomplish that end. The reason reciprocal business is difficult, legitimately, to give to nonmember broker-dealers is the ability of funds and their advisers to deal with the primary market makers in their acquisition and disposition of blocks of stock in the over-the-counter market. There are relatively few wholesale dealers making markets in securities of institutional interest as compared with the number of firms selling mutual fund shares. In the over-the-counter markets commissions and markups are subject to negotiation, and mutual funds dealing directly with primary market makers can often execute transactions at wholesale prices, a benefit not usually available to individual investors. Most funds or their advisers have their own trading or order departments [261] with employees versed in the intricacies of over-the-counter trading who, in the words of one fund, maintain "* * * personal telephone relations with a very large number of brokerage firms * * *" and "* * * have a continual knowledge of the most advantageous markets. * * *" Under these circumstances splitting over-the-counter orders among a number of small over-the-counter dealers is not justifiable because of the higher cost of execution which would generally result. The mutual fund industry has, nevertheless, devised several

[261] All of the 16 load funds and 5 no-load funds to which questionnaire IN–4 was sent reported that they or their investment advisers or managers had established special trading or order departments for supervision of portfolio transactions.

methods by which it can spread the benefits of reciprocity to nonexchange member broker-dealers.

One technique is referred to in the correspondence quoted above. Fund managers sometimes arrange to have nonexchange member dealers included in the selling group of a new underwriting of an issue, some of whose shares the fund intends to purchase, or a secondary offering of an issue which the fund intends to purchase or sell. In this type of reciprocal business the dealer is required to do nothing except receive a check from the managing underwriter for its share of the selling group concession. The managing underwriter handles all details of bookkeeping and the delivery of the shares. The fund, at the same time, incurs no additional expense through the use of a number of dealers acting as members of the selling group, since the price of the shares and the spreads have already been fixed by negotiation between the issuer and the managing underwriter. If a fund participated in such offerings primarily in order to reward nonexchange member dealers, a conflict of interest would be created, but it would be very difficult to determine the existence of any such conflict.

Another device occasionally used to extend the benefits of reciprocity to nonexchange members is known as a "trade-off." Under this arrangement a fund manager directs NYSE-listed business of the fund to an Exchange member firm with a request that the Exchange firm in turn direct over-the-counter transactions to nonmember firms designated by the fund.

Probably the most common method of benefiting nonexchange member dealers, however, is the so-called service give-up. Under this arrangement, the fund manager will direct the NYSE member firm serving as its primary broker to give up a portion of its commission to a second NYSE member firm, which in turn renders services to the nonmember. The services rendered by the member to the nonmember firm are most frequently the sales promotion services discussed in the preceding section, and the pressure to reciprocate nonmember dealers through some method has undoubtedly contributed to the growth of the sales promotional services produced by the five member firms there referred to. The preponderance of the services provided by those firms is in exchange for commissions or commission credits rather than for cash, and the estimate by a partner of one of those firms that his firm provides its services to 40 percent of the mutual fund industry suggest the widespread use of the service give-up. As might be expected, some of the nonmember dealers would prefer to receive the reciprocal business to which they feel entitled in cash rather than merchandise. One such dealer wrote to the Commission:

> A nonmember dealer (not NYSE) works his head off to create millions in brokerage business—and services the funds' clients for years and years in dozens of ways but can't get cash for this extra service. This is wrong!

In their efforts to provide cash compensation to nonmember broker-dealers to reciprocate for the sale of fund shares, some funds and their advisers turn to practices in transactions in over-the-counter securities which resemble the give-up in exchange transactions. The use of the give-up in over-the-counter transactions, however, poses conflicts of interest which do not exist in the present framework of the exchange markets because of the absence of a minimum commission rate structure. In the over-the-counter market a give-up by an executing broker

to another broker inevitably raises the issue of whether the fund involved obtained the best possible price in the transaction. Despite a general awareness by most funds of the obligation to their stockholders to obtain the best possible terms in all transactions, situations came to the attention of the study suggesting that this objective is not always achieved when over-the-counter securities are bought or sold.

An example of an outright over-the-counter give-up occurred in connection with the purchase by one mutual fund in June 1961, of 12,900 shares of Bell & Howell, an NYSE-listed stock, through an over-the-counter firm. The firm, acting as agent for the purchasing fund, acquired the block of shares from a second fund and charged a commission of $5,800 to the first fund at the NYSE rate. Its confirmation noted that it was "a designated sale," and that the firm would participate in the commission only for a total of 6,450 shares and would confirm and deliver. The balance of the commission was shared in by 14 other nonmember firms. While the fund acquired its block of listed stock at the Exchange commission rate, the broker's willingness to give up half of its commission suggests that the fund could have acquired the block for substantially less.

Another method of accomplishing an over-the-counter give-up is by interposing a selected nonmember broker-dealer between the primary broker and the fund. One member of the industry has described the practice as—

* * * where a fund will go to a primary market and locate stock, and then go to secondary firm and say, "we want such and such a security, and if you go to firm A, which is the primary market, you can get it at a certain figure"; and then have the secondary firm [confirm] at a commission or markup of some sort.

A concrete example of interpositioning in over-the-counter transactions which came to the attention of the NASD in 1959 involved a Boston mutual fund underwriter, one of the funds it underwrote, and a retail specialist in mutual fund shares. In one of the questionable transactions, which involved the sale of an over-the-counter oil stock held by the fund, the fund underwriter instructed the retailer to sell 4,000 shares of the stock and simultaneously gave it the name of an NYSE firm which would purchase the shares. The NYSE firm took delivery of the share certificates directly from a bank designated by the underwriter and sent a check for the proceeds directly to the fund, after deducting a commission for the retailer, who received $800 for his "services."

Although the Special Study found no widespread incidence of give-ups in the over-the-counter market in listed securities,[262] responses to one questionnaire indicated that a few firms had sometimes provided give-ups or interposed other firms when acting as principal or agent in the over-the-counter purchase or sale of NYSE-listed securities. Some of the firms indicated that such transactions were against their present policies, and that they had occurred inadvertently or prior to institution of their policies. One firm apparently viewed the over-the-counter give-up as raising no problems so long as the fund paid no more than it would have paid as an NYSE commission in a transaction executed on the Exchange. The firm stated:

If our "customer" is an institution who wishes to enable an NASD member to obtain a commission (or a fraction of the regular commission) we are willing

[262] See ch. VIII.D.6.d.

APPENDIX B.

List of Exhibits.

List of Exhibits.